# The Stockholder's Statutory Right to Inspect Corporate Books and Records

Megan D. McIntyre

©2010 Grant & Eisenhofer P.A.

Stockholders, as corporate owners, have both a right and a need to receive information relevant to the decisions they need to make in protection of their interests, including decisions about how to vote their shares, whether to sell, and whether legal action is necessary. Indeed, "[a]s a matter of self-protection, the stockholder [is] entitled to know how his agents [are] conducting the affairs of the corporation of which he or she [is] a part owner."[1] Even corporate managers acting with the best of intentions may neglect to disclose such information, or may provide disclosures that are insufficiently detailed to enable stockholders to make adequately informed decisions. Fortunately, stockholders need not "fly blind" in such situations, because the law offers them a means to demand access to corporate documents.

Section 220 of the Delaware General Corporation Law, 8 Del. C. § 220, like many state inspection statutes, presents stockholders of Delaware corporations with an opportunity to obtain information under the control of company leadership.[2] "The statute is an expansion of the common law right of shareholders to protect themselves by keeping abreast of how their agents [are] conducting corporate affairs."[3] When asserted properly by stockholders with a genuine need for information, the statutory right of inspection is an indispensable investigative tool. In fact, the Delaware courts actively encourage stockholders to utilize this tool before pursuing litigation alleging corporate management, and will often dismiss complaints containing vague allegations if the plaintiff stockholder did not exercise inspection rights before filing suit.[4] The Court of Chancery has explained that "[a]fter the repeated admonitions of the Supreme Court to use the 'tools at hand' [i.e., Section 220] … lawyers who fail to use those tools to craft their pleadings do so at some peril."[5] Exercise of the statutory inspection right also facilitates correspondence between stockholders regarding matters of common interest, such as shareholder lawsuits or proxy contests.

This article will discuss not only the provisions and scope of the stockholder's statutory inspection rights under Section 220, but also the reasons why stockholders should seriously consider exercising these rights before filing a lawsuit against corporate management. It will also address some of Section 220's limitations.

## Overview of a Stockholder's Rights under Section 220

Section 220 provides that any stockholder of a Delaware corporation, no matter how many shares she owns or for how long she has held them, "shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from … the corporation's stock ledger, a list of its stockholders, and its other books and records." A requesting stockholder may also demand a list of the beneficial owners of the company's stock.

The statutory right to inspect corporate books and records extends to the records of corporate subsidiaries as well, so long as (a) the parent corporation has possession and control of the records sought, or (b) the parent could obtain them through the exercise of control over the subsidiary – at least when the subsidiary has no legal right to deny its parent access to its records. The statute also denies inspection rights if allowing access to a subsidiary's records would violate an agreement between the parent or the subsidiary and a third party. A "subsidiary," for purposes of Section 220, includes (a) a wholly owned company; or (b) a company owned directly or indirectly, in whole or in part, whose affairs are directly or indirectly controlled by the corporation.[6]

If a corporation refuses to comply with a properly exercised demand for inspection of its books and records, a stockholder may initiate a lawsuit to compel the inspection. Specifically, if a corporation fails to respond to the demand within five business days, the stockholder may file a summary proceeding in the Delaware Court of Chancery pursuant to Section 220(c). Because proceedings under Section 220(c) are limited to the narrow purpose of enforcing the stockholder's inspection rights, and because the Delaware Supreme Court has said that such proceedings "should be managed expeditiously,"[7] they can often be resolved within a few months. A stockholder may also move the Court to expedite the proceedings even further when, for example, information is needed for purposes of an impending stockholder vote.

## Section 220's Technical Requirements

When making a demand under Section 220, a stockholder must take great care to comply with all of the statute's procedural requirements Failure will almost certainly result in rejection of the demand by the corporation, and may well cause the court to deny a request to enforce it.[8]

The statute requires that a demand be made in writing, under oath, and directed to the corporation's registered office in Delaware or to its principal place of business. Section 220 further obliges the demanding stockholder to state with specificity her purpose for seeking the inspection. The demand must also identify, with as much precision as possible, the specific documents sought.[9] If the stockholder making the request is not a record holder of the corporation's stock, her demand must "state [her] status as a stockholder, be accompanied by documentary evidence of beneficial ownership of the stock, and state that such documentary evidence is a true and correct copy of what it purports to be." No specific form of documentary evidence is required, but it must be adequate to demonstrate the stockholder's beneficial ownership of stock on the date of the demand.[10] Additionally, if a stockholder's attorney or agent makes the demand, she must include with the demand a power of attorney or other written authorization from the stockholder.

In addition to fulfilling Section 220's procedural requirements, a stockholder must show, by a preponderance of the evidence, that she has a proper purpose

in making her demand. In fact, the "proper purpose" requirement is the "paramount factor in determining whether a stockholder is entitled to inspection."[11] If the stockholder seeks merely to obtain the company's stock ledger or stockholder list, a proper purpose is presumed; it is then the company's burden to prove that the stockholder's purpose is improper. If the stockholder seeks other kinds of corporate books and records, however, the burden of proof is hers to satisfy.

Section 220 defines a "proper purpose" as "a purpose reasonably related to [the demanding stockholder's] interest as a stockholder." Such a purpose cannot be adverse to that of the corporation. Nor may the demand be intended only to harass, or be made in bad faith. If a stockholder has more than one purpose in seeking corporate books and records, a court will permit the demand so long as the stockholder's primary purpose is proper – even if any subordinate purpose is improper.

Determining whether a stockholder's stated purpose comports with her interest as a stockholder requires a detailed factual analysis. Thus, any judicial evaluation will turn on the particular circumstances of the pending case. Several examples of purposes deemed "proper" by Delaware courts are described in the paragraphs below.

## An Investigation into Suspected Mismanagement is Often a "Proper Purpose"

While "[t]here is no shortage of proper purposes under Delaware law … perhaps the most common … is the desire to investigate potential corporate mismanagement, wrongdoing, or waste."[12] If successful, such a demand can assist in the preparation of a lawsuit against corporate leadership, the waging of a proxy campaign, or even the formulation of a stockholder proposal for consideration at the next annual meeting.

Delaware courts will accept an investigation into suspected wrongdoing as a proper purpose so long as the stockholder demonstrates, by a preponderance of the evidence, that a credible basis exists from which one can infer the occurrence of actual mismanagement. Stated differently, the stockholder may not engage in an aimless "fishing expedition" for evidence of mismanagement, but must make a "credible showing, through documents, logic, testimony or otherwise that there are legitimate issues of wrongdoing"[13] that she wishes to investigate.

The "credible basis" evidentiary standard "sets the lowest possible burden of proof,"[14] but the courts do not always find it to be met, even in circumstances that would appear relatively egregious to the average stockholder. A recent example is a case where the Delaware Court of Chancery denied a demand seeking books and records related to the application of a relatively new phenomenon in corporate law, a "Pfizer-style" director election policy, because the stockholder failed to proffer sufficient evidence of wrongdoing. *In City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*,[15] the board of directors was presented with, and attempted to fend off, a hostile takeover bid. During the course of the board's defensive efforts, three of the company's directors came up for reelection and the Axcelis stockholders, unhappy with the board's handling of the tender offer, withheld their votes for those directors. As a result, the directors did not receive a majority of the votes cast in the election. Axcelis has a "Pfizer-style" policy (also referred to as "majority voting light") that requires directors to tender their resignations if they do not receive affirmative support from a majority of stockholder votes cast, so the three directors submitted their resignations as required. However, the remaining directors decide to reject those resignations (as permitted by the policy), claiming that the board would benefit from the expertise of these directors in negotiating with the tender offeror.

Shortly after the directors' resignations were rejected, the bidder walked away from the negotiations. Just a month later, faced with liquidity issues, the Axcelis board sold the company's most valuable asset to the same suitor for less than the initial offer price. Sensibly concerned with this turn of events and wanting to investigate, one of the company's stockholders sued to enforce its inspection rights under Section 220. The Court of Chancery, however, found that the stockholder offered insufficient evidence to support a suspicion of wrongdoing. Instead, the Court opined that the board, in rejecting the directors' resignations, properly exercised the discretion given to it by the company's Pfizer-style policy. It also accepted the company's claim that the directors simply exercised their business judgment in rejecting the hostile tender offer. The Court then held that it had no choice but to defer to that business judgment by denying the stockholder's demand for inspection. This case illustrates the need to present the strongest evidentiary showing possible in support of a demand to inspect records for the purpose of investigating mismanagement, because the courts do not always apply the "credible basis" standard in the way stockholders might expect.

Additionally, while Section 220 serves as an invaluable tool to investigate suspected corporate misbehavior, the evidentiary prerequisites to an inspection for this purpose may delay the exercise of inspection rights. Absent a compelling need for expedited review, a stockholder seeking to investigate mismanagement may face extended judicial proceedings targeted to assessing the merits of her suspicions and the facts available to support them. For example, in a Section 220 case tried by this firm involving alleged stock option backdating,[16] the Court of Chancery allowed for inspection of a portion of the documents requested — but only after conducting a thorough evidentiary hearing. The hearing included, *inter alia*, testimony from competing expert witnesses regarding whether, statistically speaking, some of the company's stock option grants might be backdated. By the time the Court issued its ruling and the stockholder conducted its inspection of the requested documents, more than a year had passed since the date of the initial demand.

## Other Purposes Deemed "Proper" By Delaware Courts

Not every "proper purpose" will necessitate an extended evidentiary hearing or a sophisticated argument regarding the scope of the business judgment presumption. In general, stockholders may successfully assert a "proper purpose" under Section 220 when they seek information related to the their pecuniary interest in the company or the exercise of their rights as a stockholders. For example, courts have accepted Section 220 demands that requested information to: evaluate directors' independence when deciding whether to make a demand upon them to bring a derivative suit; determine the suitability of directors to serve on the board; communicate with fellow stockholders regarding proxy contests or to otherwise influence company management; correspond with other stockholders regarding a potential class action lawsuit against the company; discuss with other stockholders pending merger proposals and whether to seek an appraisal remedy; and perform a valuation of a stockholder's holdings.

## Improper Purposes under Section 220

A court will not consider every asserted purpose proper. Among the purposes deemed improper by Delaware courts are those seeking books and records to, e.g., facilitate a tender offer when a court previously enjoined the demanding stockholder from pursuing such an offer; value the company as a whole to determine whether to increase the price of a tender offer; collect information for use in a personal employment-related lawsuit against the corporation; exert leverage on a third party regarding a labor union strike; improve the stockholder's personal bookkeeping methodology; or merely satisfy the stockholder's idle curiosity.

Another purpose considered improper by courts is the gathering of evidence for use in pending securities fraud litigation. Delaware courts have refused to enforce Section 220 inspection rights when they seek documents specifically protected by the automatic stay provisions of the federal securities laws. The Private Securities Litigation Reform Act, or "PSLRA," provides that discovery in federal securities cases is stayed pending the resolution of motions to dismiss.[17] Conflicts may arise between the PSLRA and Section 220 when a stockholder makes requests inspection of records relevant to a securities lawsuit that is subject to the PSLRA's discovery stay. Over the past year, the Delaware Court of Chancery has confirmed the preemptive effect of the PSLRA over Section 220 demands in certain circumstances.

In *Beiser v. PMC-Sierra, Inc.*,[18] the Court declined to enforce a demand requesting documents regarding suspected stock option backdating after it found that the demand's only perceivable purpose was to circumvent the PSLRA's mandatory stay provisions. The stockholder sought to enforce his Section 220 rights after the federal tribunal trying his related securities law claims imposed a stay on discovery pursuant to the PSLRA. The Delaware court considering the stockholder's demand concluded that he was prevented from asserting that his "proper purpose" was to investigate possible mismanagement and to eventually file a derivative action. The stockholder had, after all, already filed a lawsuit against corporate management, and had not made its Section 220 demand until nearly two years later. As the stockholder failed to assert any other plausible proper purpose, the Court reasoned that he could have only meant to thwart the stay of discovery in his federal action. Notably, the stockholder had already moved the federal court, unsuccessfully, to compel the production of similar documents in the federal litigation.[19]

While the *Beiser* Court remarked that "Congress did not intend to preempt Section 220 actions through the enactment of the PSLRA," it also noted that "Delaware courts have … anticipated that Section 220 actions might be used to circumvent the PSLRA."[20] Therefore, the Court observed, a stockholder may make a demand for books and records during pending securities litigation only if (1) neither the stockholder nor its attorneys are involved in the litigation; and (2) the stockholder enters into a confidentiality agreement preventing it from sharing of the fruits of its investigation with anyone involved in the litigation. The plaintiff in Beiser could prove none of these conditions.

## The Importance of Tailoring the Scope of a Section 220 Demand

After satisfying the statute's technical and procedural requirements, including the successful assertion of a "proper purpose," a stockholder must take care to focus her demand appropriately. Because courts will only allow the inspection of documents that are "essential and sufficient" to fulfill the purpose of the inspection, a demanding stockholder must couch her demand with as much precision and specificity as possible. For example, if a stockholder seeks documents to pursue an investigation into suspected corporate mismanagement and anticipates filing a lawsuit, her demand should only request those books and records "required to prepare a well-pleaded complaint."[21]

A stockholder may also face restrictions imposed by the court. Under a duty to protect the corporation's interests, a court must, after reviewing a demand, customize its scope and prescribe any limitations that it deems just and proper.[22] Accordingly, a court may confine a stockholder to a universe of books and records smaller than those truly considered "essential and sufficient," especially when the demand seeks documents protected by the attorney-client privilege or work product doctrine. It might also, after weighing the benefits of allowing inspection against the harm it might cause to the corporation, further restrict stockholder access. A court will also commonly require parties to enter into a reasonable confidentiality order to protect such information as trade secrets, directors' and officers' preliminary and informal

discussions, confidential communications, or individuals' salary agreements.

## Conclusion

Ideally, of course, a company should voluntarily disclose enough information to resolve all its stockholders' questions. Discussions during annual meetings, proxy statements and periodical financial reports should, theoretically, prove sufficient to satisfy any lingering stockholder uncertainty. Nevertheless, these disclosures are frequently insufficient and may even create additional concerns. It is in these circumstances that stockholder inspection statutes – particularly Delaware's Section 220 – provide valuable and effective investigative tools. By carefully tailoring a demand and ensuring compliance with the statutory requirements, a stockholder can materially aid its understanding of important corporate events and issues, leaving it better-informed to make the many significant decisions facing stockholders today.

1 *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 116 (Del. 2002).

2 An analogous right exists for Delaware limited liability company members. *See 6 Del. C.* § 18-305.

3 *Melzer v. CNET Networks, Inc.*, 934 A.2d 912, 917 (Del. Ch. 2007).

4 *See, e.g., Brehm v. Eisner*, 746 A.2d 244, 266-67 (Del. 2000).

5 *Mizel v. Connelly*, 1999 WL 550369, *5 (Del. Ch. Aug. 2, 1999).

6 The term "control" here does not necessarily require the corporation be able to obtain the subsidiary's records. *Weinstein Enters., Inc. v. Orloff*, 870 A.2d 499, 508-10 (Del. 2005). Thus, it is possible that a company might qualify as a corporation's "subsidiary" under the statute, but that the stockholder cannot obtain books and records by making a demand on the parent. *Id.*

7 *Brehm*, 746 A.2d at 267.

8 *See, e.g., Seinfeld v. Verizon Commc'ns, Inc.*, 2005 WL 147765, at *2 (Del. Ch. Jan. 21, 2005); *Mattes v. Checkers Drive-In Restaurants, Inc.*, 2000 WL 1800126, at *1-2 (Del. Ch. Nov. 15, 2000); *Norton v. Health-Pak, Inc.*, 1999 WL 252380, *1 (Del. Ch. Apr. 12, 1999).

9 *See Brehm*, 746 A.2d at 266.

10 *See Smith v. Horizon Lines, Inc.*, 2009 WL 2913887, *2 (Del. Ch. Aug. 31, 2009) (evidence is insufficient where it is "so heavily redacted that it cannot be read to show plaintiff was a beneficial owner … on the relevant date").

11 *CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 792 (Del. 1982).

12 *Melzer*, 934 A.2d at 917 (internal citation omitted).

13 *Security First Corp.*, 687 A.2d at 567-68.

14 *Louisiana Mun. Police Employees' Ret. Sys. v. Countrywide Fin. Corp.*, 2007 WL 2896540, *11 (Del. Ch. Oct. 2, 2007) (citation omitted).

15 2009 WL 3086537 (Del. Ch. Sept. 28, 2009).

16 *Louisiana Municipal Police Employees' Retirement System v. Countrywide Financial Corp.*, 2007 WL 2896540 (Del. Ch. Oct. 2, 2007).

17 Securities Act of 1933, §27(b)(1), 15 U.S.C.A. §77z-1(b)(1) and Securities Exchange Act of 1934, §21D(b)(3)(B), 15 U.S.C. §78u-4(b)(3)(B).

18 2009 WL 483321 (Del. Ch. Feb. 26, 2009).

19 Similarly, the Court denied a Section 220 demand for the inspection of books and records in *Norfolk County Retirement System v. Jos. A. Bank Clothiers, Inc.*, 2009 WL 353746 (Del. Ch. Feb. 12, 2009). Just as in the *Beiser* case, the plaintiff there made a Section 220 request months after filing a related federal securities lawsuit.

20 *Beiser*, at *3.

21 *Kaufman v. CA, Inc.*, 905 A.2d 749, 753 (Del. Ch. 2006).

22 8 *Del. C.* § 220(c).


Grant & Eisenhofer