

Chancery Court Continues Close Scrutiny in Section 220 Actions



James L. Hallowell
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Section 220 of the Delaware General Corporation Law affords shareholders of Delaware corporations the right to inspect the books and records of corporations in which they hold an ownership interest. This right is subject to compliance with certain form and manner requirements and a demonstration that the shareholder seeks the inspection for a proper purpose, defined as a purpose reasonably related to the requester's interest as a shareholder. The shareholder has the burden of showing, by a preponderance of the evidence, a proper purpose for each item sought.

For nearly two decades, Delaware courts have encouraged the use of Section 220 requests by shareholders seeking to effect policy, personnel or governance reforms within Delaware corporations. See, e.g., *Rales v. Blasband*, 634 A.2d 927, 935 n.10 (Del. 1993) and *South v. Baker*, C.A. No. 7294-VCL (Del. Ch. Sept. 25, 2012). Nevertheless, and perhaps mindful of the high costs associated with indiscriminate books-and-records requests, Dela-

ware courts have not relaxed the statute's substantive and procedural requirements. Indeed, in a pair of recent decisions, *Louisiana Municipal Police Employees' Retirement System v. Lennar*, C.A. No. 7314-VCG, 2012 Del. Ch. LEXIS 230 (Del. Ch. Oct. 5, 2012) (LAMPERS), and *Rock Solid Gelt Ltd. v. SmartPill*, C.A. No. 7100-VCN, 2012 Del. Ch. LEXIS 234 (Del. Ch. Oct. 10, 2012), the Chancery Court applied careful scrutiny to the purposes shareholders asserted in their Section 220 requests.

In LAMPERS, a shareholder of homebuilder Lennar Corp. sought inspection of books and records pertaining to Lennar and its subcontractors' compliance with various federal and state laws. The purpose of LAMPERS' request was to investigate Lennar's potential mismanagement regarding alleged improper classification of employees under the Fair Labor Standards Act. LAMPERS proffered in support of its request: (1) two *Wall Street Journal* articles detailing an industrywide federal investigation

of labor practices that included Lennar and (2) several labor lawsuits Lennar settled between 2007 and 2009. Noting that investigation of mismanagement is a proper Section 220 request purpose, Vice Chancellor Sam Glasscock III nevertheless required LAMPERS to demonstrate, in keeping with longstanding precedent, "some evidence of possible mismanagement as would warrant further investigation of the matter," quoting *Helmsman Management Services v. A & S Consultants*, 525 A.2d 160, 165-66 (Del. Ch. 1987). Reviewing the news reports and prior lawsuits both independently and together, the court concluded that LAMPERS failed to demonstrate "some evidence" of misconduct sufficient to support a Section 220 demand.

In *Rock Solid*, the plaintiff shareholder Rock Solid requested access to corporate records in the wake of defendant SmartPill Corp.'s proposed preferred stock refinancing, which would have caused Rock Solid's preferred stockholdings to dilute and convert to common

shares. Rock Solid sought information concerning four issues: (1) whether SmartPill's board of directors breached its fiduciary duties in the course of the financing and stock conversion; (2) the independence of the SmartPill special committee; (3) the value of Rock Solid's shares in SmartPill; and (4) whether SmartPill's board breached its fiduciary duties in executing a more favorable stock purchase agreement with another minority shareholder. Regarding issues 1 and 4, Vice Chancellor John W. Noble ruled that Rock Solid had not demonstrated a proper purpose for its Section 220 demand. In so holding, the court rejected Rock Solid's contentions that the dilutive nature of the refinancing was sufficient to show a credible basis to infer that corporate waste or mismanagement had occurred. The court similarly held that execution of a more favorable stock purchase agreement with another shareholder, without more, was insufficient to support an inference of improper conduct. As to issues 2 and 3, the court granted Rock Solid partial relief: Rock Solid received materials that were "essential and sufficient" for its shareholder valuation, because the court held specifically that the valuation of a shareholder's shares is a proper purpose for a Section 220 demand. Further, having found a proper purpose for inquiries concerning the special committee's independence and the market check it performed in connection with the refinancing, the court ordered inspection as to the "essential and sufficient" documents associated with those inquiries,

and otherwise denied Rock Solid's application.

Rock Solid and LAMPERS continue the rigorous review that the Court of Chancery has applied regarding the "credible basis" of possible mismanagement, waste or wrongdoing needed to support further investigation through a Section 220 inspection. This is noteworthy because there is no requirement for a mere inspection request that a shareholder prove that waste or mismanagement are actually occurring. Indeed, *Rock Solid* noted that Section 220 requests should be granted even if the evidence "may ultimately fall well short of demonstrating that anything wrong occurred."

Rock Solid is further noteworthy because it reaffirmed the limited scope of relief often afforded even when Section 220 plaintiffs prevail. The court criticized Rock Solid for seeking access to an "overly broad" listing of books and records that it compared to "voluminous document discovery under Court of Chancery Rule 34." Though tempted to entirely deny relief "simply because the requests are so broad," and while opining that "the court should not be burdened with clearing away the clutter that an unjustifiably broad request produces," the court instead identified the "essential and sufficient" responses to the plaintiff's requests on a document-by-document basis and denied relief as to the balance.

Rock Solid and *LAMPERS* reflect continuing court concern with the potential for costly and unnecessary "fishing expeditions" through cor-

porate books and records. In light of these precedents, successful Section 220 demands will require both a well-articulated proper purpose and sufficient evidentiary detail, particularly as to the "credible basis" for further investigation of suspected mismanagement or wrongdoing.

James L. Hallowell is a commercial litigation partner in the New York office of Gibson, Dunn & Crutcher. **Stephen Henrick**, an associate at Gibson, Dunn & Crutcher, contributed to this article.