

Delaware Law Weekly

December 13, 2006

Volume 9, Number 50 \$8.00

ALM

Shareholder Request Denied for Books, Records Under Section 220

By Francis G.X. Pileggi

Special to the DLW

In a recent decision, the Delaware Court of Chancery added to the growing body of cases in which a request for books and records under 8 Del.C. Section 220 was denied.

DGCL Section 220 gives a shareholder the right to inspect books and records of a corporation if the purpose for inspection is a proper one. The statute defines proper purpose as any purpose "reasonably related to such person's interest as a stockholder." Although investigation of wrongdoing can be a proper purpose, the plaintiff must prove at trial some credible evidence of wrongdoing sufficient to warrant continued investigation.

In *West Coast Management & Capital LLC v. Carrier Access Corp.*, 2006 WL 3337161 (Del. Ch. Nov. 14, 2006), the court determined that the shareholder did not have a "proper purpose." A key to the court's reasoning was a decision of a federal court in Colorado which dismissed a prior stockholder derivative suit by the same plaintiff, and which the Chancery Court determined estopped the same plaintiff from relitigating the demand futility issue and also precluded the same plaintiff from filing a second derivative complaint. The stated purpose of the plaintiff's Section 220 demand was to obtain information in order to adequately plead demand futility in a proposed second derivative complaint.

The same plaintiff had previously made a Section 220 demand, without filing suit, but took no action after the company denied the demand as an improper attempt to circumvent a decision by a federal court to deny discovery during the pendency of a motion to dismiss in a separate proceeding. The instant demand came after the federal suit was dismissed for failure to plead demand futility.

Procedurally, the court made its decision based on a motion under Chancery Court Rule 12(c) for judgment on the pleadings. The court discussed the procedural standard for such a motion in light of the form and manner requirements under DGCL Section 220. The court also referred to the recent Delaware Supreme Court decision of *Braddock v. Zimmerman*, 906 A.2d 776 (Del. 2006) and Chancery Court Rule 15(aaa), recognizing that a derivative claim may be dismissed with prejudice as to the named plaintiff but not as to the corporation or its other stockholders.

The court observed that: "what is yet undecided under Delaware law and must be

FRANCIS G.X. PILEGGI is the founding partner of the Wilmington office of Fox Rothschild, an AmLaw 200 member. He maintains a blog at www.delawarelitigation.com which summarizes business law cases primarily from Delaware's Court of Chancery and Supreme Court. His e-mail address is fpileggi@foxrothschild.com.



resolved by this court is, in the absence of a dismissal with prejudice to the specific individual derivative plaintiff, whether that plaintiff can file a second case and replead demand futility. That is, in the absence of leave to amend, does a dismissal on demand futility alone operate as a bar to a subsequent suit by the same named plaintiff." (The court noted that other jurisdictions often use conflicting terms for this concept, such as res judicata, claim preclusion, judicial estoppel, direct estoppel, collateral estoppel and issue preclusion.)

The court also discussed that full faith and credit requires a federal court to apply state law on issue preclusion when the original decision is in state court, and although not constitutionally required, the Chancery Court adopts the same policy.

Specifically, the issue in this case was

whether the decision by the federal court to dismiss the case "without prejudice" eviscerated the issue preclusion bar to a second suit. The Chancery Court here concluded that regardless of the characterization of the prior dismissal as either with or without prejudice, the same shareholder was estopped from relitigating demand futility because it was actually litigated and determined by the federal district court, and because that determination is binding and preclusive on that shareholder in any subsequent litigation between the parties as a matter of issue preclusion.

The court also cites to authority for use of the word estoppel as opposed to issue preclusion alone. The fact that the dismissal was without prejudice simply means that the underlying claim, which belonged to the corporation and not its stockholders, was not adjudicated. The court need did not decide whether the district court order amounted to res judicata or complete claim preclusion.

The court reasoned in conclusion that "the nature of Section 220 as an independent right does not eliminate the proper purpose requirement. ... Although investigating wrongdoing is a proper purpose, it must be to some end. Delaware law does not permit Section 220 actions based on an ephemeral

Shareholder continues on page 6

Shareholder

Continued from page 3

purpose, nor will this court impute a purpose absent the plaintiff stating one.

"Simply put, West Coast must do more than state, in a conclusory manner, a generally accepted proper purpose. West Coast must state a reason for the purpose, i.e., what it will do with the information, or an end to which that investigation may lead. Here, it is clear that West Coast's sole purpose and end is to pursue a second derivative suit — an end barred by issue preclusion."

The court distinguished this case from a case where there is a "credible showing" of "legitimate issues of wrongdoing," and the plaintiff is investigating to determine the nature of the wrongdoing and what further actions may be appropriate based on that

information. Here the court found that shareholder's only purpose was to relitigate demand futility and pursue a second derivative complaint, both of which were barred.

Over the last two years or so I have summarized all the published opinions from the Court of Chancery and Delaware Supreme Court on Section 220, for my blog.

This latest case is a further example that the seemingly simple procedures in DGCL Section 220 are neither mechanically applied, nor is the result of their application always obvious. Shareholders have found that they do not satisfy the prerequisites of Section 220 when, after the court's careful analysis it appears, for example, that their purpose is not reasonably related to their status as a shareholder. See, e.g., *Polygon Global Opps. Master Fund v. West Corp.*, 2006 WL 2947486 (Del. Ch. Oct. 12, 2006).

The Delaware Supreme Court recently

rejected a Section 220 demand after agreeing with the Chancery Court's finding that there was no credible basis for the stated purpose of possible mismanagement that would warrant further investigation. *Seinfeld v. Verizon Comm's Inc.*, 2006 WL 27771558 (Del. Sept. 25, 2006). See also *Highland Select Equity Fund L.P. v. Motient Corp.*, 906 A.2d. 156 (Del. Ch. March 17, 2006)(request denied as overly broad and onerous).

In conclusion, despite the summary nature of a Section 220 proceeding, the court will carefully examine the circumstances in which the demand is made (such as related proceedings in another court or a proxy contest), and the court will closely analyze the relevant background of the shareholder to the extent it sheds light on whether Section 220 is being used for its intended purpose, as opposed to a vehicle for a fishing expedition or to pursue unfounded allegations. •