

Expert Q&A on Stockholder Inspection Demands

When the Delaware Supreme Court issued its July 2014 decision in *Wal-Mart Stores, Inc. v. Indiana Electrical Workers Pension Trust Fund*, many attorneys read it as a signal that a more expansive scope of books and records discovery was available under Section 220 of the Delaware General Corporation Law (DGCL). Yet recent case law from the Delaware Court of Chancery following *Wal-Mart* has reaffirmed prior constraints and recognized new limitations on stockholder inspection rights under Section 220. Practical Law asked *Bill Monahan* and *Adam Magid* of *Sullivan & Cromwell LLP* to discuss the current status and scope of stockholder inspection rights in this evolving landscape.



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What does an inspection demand under Section 220 of the DGCL entail?

Under Section 220, a stockholder of a Delaware corporation has a qualified right to inspect the company's books and records. This right is not unlimited. For example, Section 220 does not entitle a stockholder to the wide-ranging discovery generally available in ordinary civil litigation. (*Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 114-15 (Del. 2002); *Highland Select Equity Fund, L.P. v. Motient Corp.*, 906 A.2d 156, 165 (Del. Ch. 2006).) The Delaware Supreme Court has cautioned that "a Section 220 proceeding should result in an order circumscribed with rifled precision" (*Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 570 (Del. 1997)).

To enforce an inspection right under Section 220, the stockholder must establish both:

- A "proper purpose" for the inspection (DGCL § 220(b)).
- That the scope of the books and records the stockholder seeks to inspect is no broader than what is "necessary and essential to accomplish the stated, proper purpose" (*Saito*, 806 A.2d at 116).

What constitutes a proper purpose under Section 220, and what evidence must a stockholder present to demonstrate a proper purpose?

A proper purpose is one that is reasonably related to the person's interest as a stockholder (see DGCL § 220(b)). Investigations of alleged mismanagement, waste, or wrongdoing

by fiduciaries have been recognized as proper purposes for a books and records inspection under Section 220, and are commonly invoked by stockholders making inspection demands (*City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 1 A.3d 281, 287 (Del. 2010)).

However, as discussed in more detail below, a stockholder cannot meet the proper purpose requirement by merely stating, in conclusory fashion, that it is motivated by a commonly invoked proper purpose, such as investigating corporate wrongdoing. Rather, a stockholder must explain why that purpose is relevant to its interest as a stockholder. Reasons might include the stockholder's intention to:

- Institute a derivative action.
- Mount a proxy fight for new directors.
- Seek corporate reforms.

(*Se. Pa. Transp. Auth. v. AbbVie, Inc.*, 2015 WL 1753033, at *11 (Del. Ch. Apr. 15, 2015).)

The Court of Chancery has observed that the following materials typically are necessary and essential when investigating alleged wrongdoing:

- Minutes from relevant board meetings and board committee meetings.
- Materials provided to the board or its committees in connection with those meetings, including presentations made to the board or its committees.
- Relevant corporate policies and procedures.

(*Cook v. Hewlett-Packard Co.*, 2014 WL 311111, at *3-4 (Del. Ch. Jan. 30, 2014); *Oklahoma Firefighters Pension & Ret. Sys. v. Citigroup Inc.*, 2015 WL 1884453, at *7 (Del. Ch. Apr. 24, 2015).)

Nevertheless, as shown in *Wal-Mart*, the Court of Chancery has considerable discretion in determining the scope of inspection and prescribing any limitations or conditions it deems appropriate, based on the unique facts and circumstances of each case. For example, in *United Technologies Corp. v. Treppel*, the Supreme Court held that the Court of Chancery could,

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To establish a proper purpose of investigating corporate wrongdoing, bare allegations of wrongdoing will not suffice. Instead, Delaware courts require “some evidence” suggesting a “credible basis” from which a court can infer that mismanagement might have occurred (*Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026, 1031 (Del. 1996); *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 123 (Del. 2006)). To meet this standard, a stockholder must present evidence, whether “documents, logic, testimony or otherwise,” from which the court can infer wrongdoing (*Paul v. China MediaExpress Holdings, Inc.*, 2012 WL 28818, at *4 (Del. Ch. Jan. 5, 2012) (internal citation omitted)).

What types of documents are considered necessary and essential, when defining the scope of permissible inspection under Section 220?

In *Wal-Mart*, the Delaware Supreme Court clarified that documents are “necessary and essential” when they:

- Address the crux of the stockholder's stated purpose.
- Are unavailable from other sources.

(*Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Tr. Fund*, 95 A.3d 1264, 1271 (Del. 2014).)

in its discretion, limit the use of information gained from the inspection to legal proceedings filed in the Delaware courts (109 A.3d 553, 557-58, 561 (Del. 2014)).

In what ways was the discovery ordered in *Wal-Mart* more expansive than in previous Section 220 cases, and what was the court's reasoning?

In *Wal-Mart*, the Delaware Supreme Court allowed a wide-ranging inspection that included communications (including emails) of directors, officers, and lower-level employees, as well as materials protected by the attorney-client privilege. This led many attorneys to wonder whether the decision heralded an expansion of inspection rights that would embrace broad, litigation-style discovery to investigate corporate wrongdoing.

The inspection demand in *Wal-Mart* was premised on a news article concerning allegations that a Mexican subsidiary of Wal-Mart Stores, Inc., WalMex, made bribes to Mexican officials between 2002 and 2005. Wal-Mart executives allegedly became aware of the scheme no later than 2005 following an internal investigation that uncovered the unlawful conduct. Control of the investigation was then transferred to WalMex's general counsel, who allegedly cleared himself and other WalMex executives of any wrongdoing.

On the basis of these allegations, a Wal-Mart stockholder issued a demand under Section 220 to inspect a broad array of documents, and stated that the purposes of the inspection demand were to investigate:

- Mismanagement of the internal investigation.
- Possible breaches of fiduciary duty by Wal-Mart officers and directors.
- Whether a pre-suit demand on the board would be futile in connection with a possible derivative suit.

(95 A.3d at 1267-69.)



Search [Shareholder Derivative Litigation](#) and [Shareholder Derivative Litigation: Pre-Suit Demands from Purported Shareholders](#) for more on derivative litigation and demand futility.

After oral argument, then-Chancellor Strine of the Court of Chancery ordered Wal-Mart to produce a number of categories of documents relating to the WalMex internal investigation that it had not previously made available for inspection, including documents relating to the bribery allegations and relevant policies on internal investigations and compliance with the Foreign Corrupt Practices Act. Because it was undisputed that key officers were involved in the internal investigation, the court allowed inspection of officer-level communications, reasoning that:

- The communications related to the way that Wal-Mart conducted the internal investigation of the bribery allegations.
- The officer-level documents were critical to evaluating the extent of possible fiduciary breaches.
- Communications between officers and directors were relevant to evaluating demand futility.

(95 A.3d at 1273, 1279.) The Delaware Supreme Court affirmed, holding that the inspection order of then-Chancellor Strine (who was sworn in as Chief Justice of the Delaware Supreme Court while the appeal was pending) was not an abuse of discretion (95 A.3d at 1273).

What is the *Garner* doctrine, and what is its significance in the *Wal-Mart* decision?

Under the *Garner* doctrine, a stockholder may access the company's privileged documents in certain circumstances on a showing of "good cause." Good cause is a fact-dependent inquiry, and courts may rely on a number of factors to find good cause, including, for example:

- The nature of the stockholder's claim and its viability.
- The necessity of the stockholder having the information and its availability from other sources.
- If the stockholder's claim is of wrongful action by the corporation, whether the action is criminal, illegal, or of doubtful legality.

(*Garner v. Wolfenbarger*, 430 F.2d 1093, 1104 (5th Cir. 1970).)

After observing that previous decisions had approved the *Garner* doctrine in dicta, the Delaware Supreme Court in *Wal-Mart* affirmed the Court of Chancery's invocation of the exception and

expressly sanctioned its use in a Section 220 context. Noting that the exception is "narrow, exacting, and intended to be very difficult to satisfy," the court held that a stockholder may properly invoke the doctrine in a Section 220 action, but first must establish that the requested materials are both necessary and essential. The court reasoned that the requested documents met the necessary and essential standard in this case because they went to the crux of how Wal-Mart handled the investigation and what details were shared with the board, and it was "very difficult to find those documents by other means." (95 A.3d at 1276-80.)

For the same reasons, the Supreme Court also affirmed the Court of Chancery's ruling allowing access to materials withheld by Wal-Mart on the basis of the work product doctrine. Under Court of Chancery Rule 26(b)(3), a shareholder may access non-opinion work product on a showing of "substantial need" for the withheld materials. Observing that the *Garner* factors largely overlap with the required showing of substantial need under Rule 26(b)(3), the court held that it was not an abuse of discretion for the Court of Chancery to allow the stockholder to access materials protected by both the attorney-client privilege and work product doctrine under the circumstances. (95 A.3d at 1280-81.)



Search [Attorney-Client Privilege and Work Product Doctrine Toolkit](#) for a collection of resources to help counsel navigate the attorney-client privilege.

How has the Court of Chancery interpreted the proper purpose requirement post-*Wal-Mart*?

In a departure from past practice, the underlying merits of potential legal claims now stand at the forefront of a stockholder's right to inspect documents under Section 220. Recent Court of Chancery decisions have held that it is not enough for a stockholder to allege wrongdoing in the abstract. Instead, the alleged wrongdoing must be actionable and sufficient to support viable legal claims. These are threshold issues that must be considered before making any materials available for inspection under Section 220.

As a result, even if there is a credible basis from which to generally infer wrongdoing, a stockholder does not have a proper purpose when the investigation concerns conduct:

- For which the directors would be exculpated under the company's certificate of incorporation (*AbbVie, Inc.*, 2015 WL 1753033, at *13).
- That would not support a cause of action, even if proven (*Walther v. ITT Educ. Servs., Inc.*, 2015 WL 545331, at *14-16 (Del. Ch. Feb. 10, 2015), adopted by 2015 WL 881046 (Del. Ch. Feb. 25, 2015); *Graulich v. Dell Inc.*, 2011 WL 1843813, at *6 (Del. Ch. May 16, 2011); *W. Coast Mgmt. & Capital, LLC v. Carrier Access Corp.*, 914 A.2d 636, 641 (Del. Ch. 2006)).

Companies that exculpate their directors from liability under Section 102(b)(7) of the DGCL, which bars stockholders from recovering damages for certain director conduct, may have a valuable defense against Section 220 demands that allege

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merely breaches of the duty of care, rather than those that implicate the duty of loyalty or bad faith.

In *AbbVie, Inc.*, the Court of Chancery found that when companies exculpate their directors from liability under Section 102(b)(7), investigating conduct by directors that is covered by the exculpatory provision, such as a breach of the duty of care, for the purposes of bringing a damages claim is futile because the directors cannot be liable for damages. In these circumstances, the stockholder can establish a proper purpose only as to non-exculpated duties, such as for bad faith or breaches of the duty of loyalty. (2015 WL 1753033, at *1 (finding that the stockholder had not established a credible basis that the directors breached the non-exculpated duty of loyalty when the allegations showed, at most, a breach of the duty of care).) The Delaware Supreme Court recently affirmed this decision, with a majority of the panel agreeing with the Court of Chancery's reliance on Section 102(b)(7) to bar the inspection demand (2016 WL 235217, at *1 (Del. Jan. 20, 2016)).



Search [Fiduciary Duties of the Board of Directors](#) for more on fiduciary duties, including information on the core duties of care and loyalty and certain circumstances when the board holds heightened duties.

Search [Certificate of Incorporation \(Short-Form DE\)](#) for a sample certificate of incorporation, including an exculpation clause under Section 102(b)(7), with explanatory notes and drafting tips.

For similar reasons, a stockholder cannot establish a proper purpose when the conduct to be investigated did not cause loss or harm to the company, or otherwise would not support an essential element (such as damages) of an actionable claim as a matter of law.

For example, in *Walther*, the Master in Chancery did not permit a stockholder to inspect any documents when, even assuming mismanagement occurred, the company had not suffered any damages and was not at risk of losing its eligibility to participate in federal student loan programs (2015 WL 545331, at *14-16 (noting that a stockholder cannot use Section 220 to investigate a "wrong for which there is no remedy," which "could lead to mischief and indiscriminate fishing expeditions") (internal quotations omitted)). The Court of Chancery subsequently adopted this decision (2015 WL 881046).

While consistent with past case law from the Court of Chancery, these decisions represent an expansion of previous authority

holding that a stockholder cannot demonstrate a proper purpose to justify an inspection demand when the stockholder would lack standing to bring suit or the contemplated action would be time-barred (*Graulich*, 2011 WL 1843813, at *1, *5-6).

How have recent decisions by the Court of Chancery reined in the scope of stockholder inspection rights?

Following *Wal-Mart*, the Court of Chancery has reaffirmed that, even if the proper purpose requirement is satisfied, a stockholder typically is not entitled to wide-ranging, litigation-style discovery to investigate alleged corporate wrongdoing. Instead, the Court of Chancery has suggested that a stockholder must make an affirmative showing of substantial need to inspect documents other than relevant portions of board minutes, board materials, and corporate policies and procedures. When seeking additional materials, a stockholder must demonstrate that the inspection demand is tailored to specific allegations of mismanagement or wrongdoing. (*Oklahoma Firefighters Pension & Ret. Sys.*, 2015 WL 1884453, at *7.)

For example, in *Oklahoma Firefighters Pension & Retirement System*, a stockholder made an inspection demand under Section 220 to investigate potential mismanagement by Citigroup fiduciaries in connection with alleged fraud and money laundering at Citigroup's Mexican subsidiary. In addition to board and committee meeting minutes and materials, and relevant corporate policies and procedures, the stockholder sought communications among directors and officers. The Master in Chancery denied that request, holding that the stockholder had not shown that these communications were necessary and essential to its stated purpose of investigating the fraud and money laundering allegations. (2014 WL 5351345, at *5.) The Court of Chancery adopted the Master's decision in its entirety (2015 WL 1884453, at *7-8).

By contrast, a stockholder's demand to inspect emails between directors and company employees was permitted in *In re Lululemon Athletica Inc. 220 Litigation*. The Court of Chancery permitted this discovery because the crux of the stockholders' purpose was whether any director contacted someone at the company to investigate possible insider trading by the company's former CEO, which necessarily implicated the directors' emails. (2015 WL 1957196, at *7 (Del. Ch. Apr. 30, 2015).)

In light of these recent decisions, what key issues should counsel consider before responding to a stockholder's inspection demand that seeks to investigate corporate wrongdoing?

Counsel should assess whether the stockholder can show:

- A credible basis from which to infer actionable wrongdoing.
- That documents beyond relevant portions of board minutes and other board materials, and corporate policies and procedures, are necessary and essential.
- Good cause to invoke the *Garner* doctrine for accessing materials protected by the attorney-client privilege.

As discussed above, even when there is a credible basis from which to infer wrongdoing, the proper purpose requirement is not satisfied if that wrongdoing cannot support potentially viable legal claims due to, for example, Section 102(b)(7) exculpatory clauses or the absence of cognizable damages. Although case law continues to evolve in this area, recent decisions provide a basis for a company to argue the viability of the claims to be investigated as a full defense against an inspection demand.

If a stockholder has satisfied the proper purpose requirement, counsel should next consider the appropriate scope of

inspection. As the Court of Chancery recognized before *Wal-Mart*, relevant board minutes and other board materials generally are sufficient to investigate wrongdoing by corporate fiduciaries. Although the court in *Wal-Mart* allowed access to a wide swath of documents, *Oklahoma Firefighters* reaffirmed that relevant board minutes and materials, and corporate policies and procedures, remain sufficient in most cases.

Based on an analysis of these issues, a company may choose to reject an inspection demand outright or attempt to negotiate a reasonable scope of inspection. When the parties are not able to reach a negotiated outcome, counsel should be mindful that the Court of Chancery has considerable discretion to fashion inspection orders based on the specific circumstances, and therefore an outcome cannot be predicted with certainty. Any response to an inspection demand should be made only after careful consideration of the facts and law, and in consultation with counsel experienced in these matters.

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