



Gathering evidence for stockholder litigation: Delaware books and records inspection demands

Corporations are well-advised to carefully consider their approach toward document preparation given the increasing role of Section 220

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December 16, 2014

Plaintiffs' lawyers increasingly are obtaining pre-complaint discovery on Delaware corporations by making books and records inspection demands on behalf of stockholders. Section 220 of the Delaware General Corporation Law permits any stockholder to inspect corporate books and records, regardless of the number of shares owned in the corporation, provided that the stockholder possesses a "proper purpose" for inspection, defined under the statute as "a purpose reasonably related to [the stockholder]'s interest as a stockholder."

Numerous purposes have been held to be "proper," including determining the suitability of directors to serve on a board and waging a proxy campaign. However, inspection under Section 220 is not automatic upon a statement of a proper purpose. For instance, stockholders seeking to file derivative lawsuits commonly assert that their "proper purpose" is to investigate potential corporate wrongdoing. Stockholders who seek to investigate potential wrongdoing must first establish, by a preponderance of the evidence, a credible basis to infer possible wrongdoing. Delaware courts have long emphasized that the credible basis standard "sets the lowest possible burden of proof." Moreover, Delaware courts frequently have justified the high pleading standard in stockholder derivative actions by pointing to Section 220 as a tool for meeting that standard.

Some recent Delaware decisions have emphasized the low burden of proof required to meet the credible basis standard. For instance, in *LAMPERS v. The Hershey Company*, the Delaware Court of Chancery held that the credible basis standard was satisfied even though the stockholder's allegations consisted primarily of industry-level information versus corporation-specific facts. The stockholder's alleged purpose was to investigate whether The Hershey Company had purchased cocoa produced by child labor. The stockholder's evidence included that 70 percent of the world's chocolate came from two countries with documented use of child labor in the cocoa industry; that Hershey controlled 42 percent of the world's chocolate market; and that Hershey acknowledged that some of its cocoa products originated in those two countries, but would not disclose its suppliers. In ordering Hershey to produce documents, the Court of Chancery emphasized that the showing required to meet the credible basis standard "may ultimately fall well short of demonstrating that anything wrong occurred."

Even when there is a “proper purpose,” uncertainty remains as to the scope of inspection. Delaware courts have refrained from establishing bright-line rules regarding appropriate scope, instead undertaking this assessment on a case-by-case basis. Notably, however, the Delaware Supreme Court recently clarified in *Wal-Mart Stores, Inc. v. Indiana Electrical Workers Pension Trust Fund IBEW* that, under certain circumstances, inspection of officer and lower-level documents may be permissible when relevant to the purpose of investigating corporate wrongdoing. Among other things, the Supreme Court upheld the inspection of emails from custodians in possession of potentially-relevant information and data from back-up tapes.

Importantly, the Delaware Supreme Court also upheld the inspection of certain documents that were otherwise protected by the attorney-client privilege and attorney work product doctrine. The court held that the stockholder had established “good cause” for the inspection because the information sought was not available from other, non-privileged sources as it related in part to the conduct of Wal-Mart’s internal legal counsel.

Given the increasing role of Section 220 as a tool in the stockholder plaintiffs’ handbook, corporations are well-advised to carefully consider their approach toward document preparation, including by ensuring that the written record appropriately reflects board and management-level attention to compliance and other issues. The absence of such detail may later be cited by stockholders in derivative litigation as alleged evidence of bad faith. Further, where issues of concern are brought to the board’s attention, companies should document steps being taken to address those issues, which may help boards later sued in derivative litigation to establish that they did not ignore red flags. Finally, although the inspection of privileged documents in the Section 220 context is likely to remain the exception rather than the rule, corporations should view the *Wal-Mart* decision as a reminder that the attorney-client privilege may be overcome in the stockholder context.

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