

## Message from Our Managing Partner

In this issue, we focus on stockholder activism, M&A opportunities in this still-wobbly economy, and more.

In our lead article, Angelo Stio and Deirdre McInerney discuss stockholder inspection rights, the scope of these rights, and defenses that management may employ to deny or put limits on the information requested.

Merger and acquisition activity is likely to increase this year because of the high level of distressed debt, according to a study commissioned by Carl Marks Advisory Group LLC and Pepper. We're hosting a seminar on this topic; see page 5 for details.

We also shine this issue's spotlight on the Princeton office's construction law practice.

As always, we welcome your comments on, questions about and suggestions for this newsletter.

Michael J. Mann, Partner

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## What Every Corporate Counsel Should Know About Stockholder Inspection Rights

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As a result of the current economic crisis, public corporations have been subject to increased review from federal government agencies and state attorneys general. In addition, corporations and their boards are being scrutinized by activist stockholders – typically individual investors or equity funds – who use their stake in a corporation to put public pressure on management to achieve financial and/or non-financial goals. Among the ways that activist stockholders scrutinize corporate management is through the use of stockholder inspection rights. These are common law and statutory rights that enable stockholders to access corporate books and records for a “proper purpose.”

This article discusses stockholder inspection rights, the scope of these rights, and defenses that management may employ to deny or put limits on the information requested. Because of its rich history in dealing with corporate issues, we focus the analysis on Delaware's stockholder inspection rights statute found in Section 220 of the Delaware General Corporation Law (8 Del. C. §220).

### THE ORIGIN OF STOCKHOLDER INSPECTION RIGHTS

A stockholder's right to inspect the books and records of the corporation in which he holds stock is nothing new. In Delaware, these rights exist under common law and by statute and are regarded as fundamental to ownership in the corporation. The rationale is that stockholders are entitled to know how management is conducting the affairs of the corporation in which they are part owners.

This publication may contain attorney advertising.

## in this issue...

- 1 What Every Corporate Counsel Should Know About Stockholder Inspection Rights
- 2 Distressed M&A Outlook - Market Conditions to Produce Significant M&A Opportunities
- 3
- 4
- 5
- 6 Spotlight: Construction Law Clients Served Well by Princeton Office

## WHO, WHAT, WHERE AND WHEN - STOCKHOLDER INSPECTION RIGHTS BASICS

The current stockholder inspection statute in Delaware is found in Section 220 of the Delaware General Corporation Law. It provides as follows:

Any stockholder, in person or by attorney or other agent, 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.

While the statutory text seems straightforward, the language employed in the statute has been the subject of great interpretation.

*Who Has the Right to Inspect Books and Records?* Section 220 provides that "any stockholder, in person or by attorney or other agent" may take advantage of the inspection rights conferred by the statute. Stockholder is defined to include both record holders and beneficial owners of stock as well as members of non-stock corporations. A person or entity must be a stockholder at the time of the request for the request to be valid, but otherwise there are no threshold requirements. It makes no difference how long the stockholder has held the stock or how much stock is held. The time period and amount of shares, however, may influence whether a request is considered proper and the scope of the inspection that is permitted (discussed below).

*How, Where and When?* A stockholder's request to inspect corporate documents must be in writing and under oath. If the request is made by a stockholder's attorney or agent, a power of attorney must accompany the request. The request should state the specific documents sought and the purpose for the inspection. An inspection request must be sent to the corporation at its registered office in Delaware or at its principal place of business. Stockholders have the right to inspect and copy the requested documents during usual hours for business of the corporation. The corporation has five days from the day it receives the request to respond.

*What Can Be Inspected?* Stockholders may access three categories of documents under Section 220. These three categories are: (1) the stock ledger or list of stockholders, (2) books and records, and (3) subsidiaries' books and records. The statutory language does not elaborate on what documents are included in each category. Generally courts have interpreted the stock ledger or list of stockholders to include the list or ledger itself and "ancillary stocklist information" that is in the corporation's possession or easily obtained.<sup>1</sup> Examples of this ancillary information include: a copy of the disk on which the stocklist is stored, the list of non-objecting beneficial owners (NOBOs) maintained pursuant to SEC Rule 14d-1(c), daily transfer sheets, and lists that identify brokerage houses that hold shares. The stockholder is entitled to the same lists and data that are available to the corporation, but the corporation is not obligated to prepare lists or data that are not readily available.

Although the case law interpreting stockholder inspection rights does not provide a bright-line definition of "books and records," courts interpret this category of information to include documents, contracts, and papers relating to the business affairs of the corporation. Courts have found papers relating to the business and affairs of the corporation to include balance sheets, profit and loss statements, minutes of proceedings, board presentations, and even tax returns.

Unlike a stockholder's ability to inspect stock ledgers, stockholder lists and corporate books and records of a parent corporation, such inspection of the books and records of a subsidiary is expressly limited by statute. Section 220 provides that a stockholder may inspect the books and records of a subsidiary to the extent that the parent has actual possession and control of the records or could obtain them through the exercise of control. The statute also makes clear that a stockholder cannot inspect a subsidiary's records if the inspection would (a) breach an agreement between the corporation or the subsidiary and a person not affiliated with the corporation and (b) if the subsidiary would have the right to deny the corporation access to its books and records.

Significantly, although a requestor must be a stockholder at the time an inspection request is made, the documents that can be accessed are not necessarily limited to the time period in which the requestor has held shares. It also is not limited by the limitations period for a particular cause of action the stockholder seeks to investigate. Instead, the scope of documents a stockholder may inspect is determined by the purpose of the inspection.

## THE PROPER PURPOSE REQUIREMENT AND WHEN A CORPORATION MAY WITHHOLD INFORMATION

Section 220 provides that a corporation has five days from the receipt of a stockholder request to reply. If the corporation does not reply, the stockholder is permitted to file a complaint with the Court of Chancery and request an order compelling the corporation to respond to the request. A motion to schedule accelerated proceedings may accompany the complaint. Despite the deference given to stockholders' inspection rights, a corporation can defend against a stockholder's request on several grounds.

*Failure to Comply with Technical Requirements.* A corporation may challenge a request if it fails to conform to the "technical" requirements of the statute. For example, an inspection request is deficient if it is not in writing or under oath. Counsel, however, should also consider whether the request is technically deficient for less obvious reasons. As discussed above, Section 220 only permits stockholders or their attorneys or agents to assert inspection rights. While stockholder is defined to include both record holders and beneficial owners of stock, a corporation has valid grounds to challenge a request from a non-stockholder. Additionally, when the request is made by someone other than the record holder (e.g., a beneficial owner), the written request must state the person's status as a stockholder and be accompanied by documentary evidence of the person's beneficial ownership. The absence of either the oath or the supporting evidence invalidates the request.

*Absence of a Proper Purpose.* The basis most often cited to deny an inspection request is a lack of "proper purpose." "A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder." 8 Del. C. § 220(b). If the party's purpose is vague or not related to the stockholder's interest, the request is objectionable. Moreover, if the request is adverse to the interests of the corporation, it is also objectionable.

The burden of proving whether a request is made for a "proper purpose" depends on the materials requested. When the stockholder seeks to inspect the stock ledger or list of stockholders, the corporation must show that the request is for an improper purpose. When the stockholder seeks books and records, beyond the list of stockholders, it is the stockholder's burden to show that the request is for a proper purpose. The purpose inquiry is

IT IS ESSENTIAL THAT MANAGEMENT UNDERSTAND STOCKHOLDER INFORMATION ACCESS RIGHTS AND THE APPROPRIATE LIMITS THE LAW PLACES ON THESE RIGHTS. MANY A LITIGATION BEGINS WITH A SEEMINGLY INNOCUOUS REQUEST BY A STOCKHOLDER TO ACCESS BOOKS AND RECORDS.

fact-sensitive and whether a purpose is proper will depend on the circumstances in each case. In general, proper purposes to request the stock ledger include:

- to solicit proxies or stockholders' consent
- to solicit support for derivative litigation
- to evaluate settlement of a derivative litigation
- to communicate with stockholders regarding a tender or exchange offer, and
- to identify potential buyers and sellers.

In general, proper purposes to request books and records include purposes to:

- learn the propriety of dividend distribution
- calculate the value of the stock
- investigate mismanagement, self-dealing, or corporate waste
- test the propriety of public disclosures, and
- inquire regarding the independence of directors.

Even though these purposes are commonly accepted as proper, a party must do more than merely state the purpose. The requesting party must provide a reason for the purpose. That is, a requesting party must articulate what it intends to do with the

information or where an investigation of the information may lead. For example, the investigation of mismanagement is generally regarded as a proper purpose. However, without providing some evidence of possible mismanagement that would warrant further investigation, the request sounds more like a fishing expedition and will be deemed improper. Similarly, if a party states that its purpose is to value the corporation's stock, but the party does not show a need for the valuation, the purpose is not valid. Once a party demonstrates at least one proper purpose, any secondary purpose or ulterior motive that may underlie the request is irrelevant.

Similar to the assessment of proper purpose, the evaluation of improper purpose is fact-specific. Generally improper reasons to request either the stock ledger or other books and records include evidence that: (a) the stockholder will try to sell the information to others, (b) the information will be given or used by competitors, (c) the purpose is to harass, (d) the purpose is to gain leverage over the corporation, or (e) the purpose is to conduct a fishing expedition or idle curiosity.

*Limitations on Materials That Can Be Inspected.* The analysis of access to books and records does not end with the finding of a valid proper purpose. The case law reveals that the Chancery Court has broad discretion to restrict the scope of any inspection. In this regard, when reviewing stockholder requests, the court is expected to safeguard both the rights of the stockholder and the legitimate interests and rights of the corporation.

In this regard, it is well-recognized that a Section 220 request is not equivalent to typical discovery requests made pursuant to Fed. R. Civ. P. 34 or Court of Chancery Rule 34. Stockholder inspection rights are distinctly different from – and far more restricted than – a litigant's discovery rights. While the scope of discovery is broad, a stockholder's right to compel the inspection of corporate information is narrowly construed. As the Supreme Court of Delaware cautioned, when a stockholder requests corporate documents, the request must be "circumscribed with *rifled precision*." *Security First Corporation v. U.S. Die Casting and Development Corp.*, 687 A.2d 563, 570 (Del. 1997) (emphasis added). In other words, only those documents that are "essential and sufficient" or "necessary and essential" to the stockholder's purpose should be included in the court-ordered inspection. *Kaufman v. CA, Inc.*, 905 A.2d 749, 753 (Del. Ch. 2006); *Helmsman Mgmt. Servs., Inc. v. A&S Consultants, Inc.*, 525 A.2d 160, 167 (Del. Ch. 1987).

Like the proper purpose inquiry, the "rifled precision" analysis is specific to the facts of each case. If the proper purpose underlying the stockholder's request is to evaluate a possible mismanagement, a party is only entitled to inspect the books and records related to the acts of mismanagement, and nothing more. An example of the rifled precision inquiry is found in the decision in *Khanna v. Covad Communications Group, Inc.*, No. 20481, 2004 WL 187274 (Del. Ch. 2004). There, a stockholder asked the court to compel a company to produce all e-mails, letters and communications between the stockholder and the company and all e-mails, letters and communications exchanged between and among the company's directors. The stockholder claimed the proper purpose for requesting this information was to investigate whether the directors breached their duties or otherwise acted unlawfully and to evaluate whether there was a valid basis to bring an action to challenge certain transactions. In rejecting the request, the court made clear that a stockholder's right to inspect a corporation's books and records "does not open the door to the wide ranging discovery that would be available in support of litigation." *Id.* at \*7. The court went on to hold that the scope of the request for e-mails, letters and correspondence was "overly broad," "excessive," and the plaintiff had not shown any necessity for the information. *Id.* at \*9.

*Attorney-Client Privilege and Confidentiality.* Finally, a corporation may assert that the documents requested are privileged and/or confidential if they contain important proprietary information such as trade secrets or attorney-client communications. A stockholder's right to inspection must be balanced with a corporation's legitimate interest in protecting from public disclosure its proprietary information or legal advice received from counsel. While a court may permit a stockholder to inspect confidential documents despite the corporation's objection, it often will condition their production on a reasonable confidentiality order or other limitations restricting the use of the information. *See CM&M Group, Inc. v. Carroll*, 453 A.2d 788 (Del. 1982) (limiting disclosure of documents pursuant to Section 220).

## CONCLUSION

During these troubling financial times, the use of stockholder inspection rights is on the rise. Since a corporation cannot restrict or limit stockholder inspection rights by amendments to its bylaws or corporate charter, it is essential that management understand stockholder information access rights and the appropriate limits the law places on these rights. Many a litigation begins with a seemingly innocuous request by a stockholder to access books and records. Before responding to this request, management should understand the who, what, where, and when of information that is accessible by stockholders.

## ENDNOTES

- 1 Donald J. Wolfe Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery*, § 8.06 (2009).

## Distressed M&A Outlook - Market Conditions to Produce Significant M&A Opportunities

Tuesday, January 19, 2010

7:30 a.m. - Registration and Breakfast

8:00 - 9:00 a.m. - Roundtable Discussion

The Harvard Club of New York City

35 West 44th Street

New York, NY 10036-6645

To gain perspective on the current distressed M&A market, Pepper Hamilton LLP and Carl Marks Advisory Group LLC commissioned mergermarket, a research and publishing company, to survey a diverse group of corporate executives, private equity practitioners, hedge fund investors and lawyers regarding the foremost issues facing distressed investors today.

Join us for breakfast as we discuss the findings of our survey on the distressed M&A market and how the landscape has changed since the survey was conducted, including the Chrysler/GM effect, the imposition of politics on the financial markets and the repercussions of CIT.

### Moderator

*James D. Rosener*, partner, Pepper Hamilton LLP

### Panelists

*Todd A. Feinsmith*, partner, Pepper Hamilton LLP

*Warren H. Feder*, partner,

Carl Marks Advisory Group, LLC

*Lawrence E. Klaff*, principal,

Gordon Brothers Group, LLC

Register online at

[https://www.regonline.com/distressed\\_NewYork](https://www.regonline.com/distressed_NewYork).

Please contact Brian Dolan at [dolanb@pepperlaw.com](mailto:dolanb@pepperlaw.com) with questions about this event.

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## Spotlight: Construction Law Clients Served Well by Princeton Office

Princeton construction attorneys, including partner Jonathan Preziosi and associate Stephanie Jonaitis, continue to provide on-the-ground legal counseling to construction project owners, contractors and subcontractors at all stages of project disputes, ranging from the representation of clients in bid protests, to the negotiation of mid-project change order requests and schedule disputes, to the litigation and arbitration of multimillion-dollar construction claims. Jonathan's clients include heavy industrial contractors who perform power plant upgrades, refinery and petrochemical plant maintenance and turnarounds, and other specialized work for the energy and industrial markets throughout the United States. In addition, Jonathan and Stephanie represent diverse types of clients in the filing and enforcement of construction liens in New Jersey and New York. From Princeton, they also manage construction lien actions in foreign jurisdictions throughout the country.

In addition to project counseling and litigation of construction disputes, the Princeton office also represents clients involved in major transportation projects including bridge, highway and airport construction. The Princeton construction attorneys provide construction contract counseling, drafting and negotiation services. Using standard forms for the industry as well as custom agreements, Stephanie provides owners, contractors and subcontractors with assistance in reviewing, preparing and analyzing agreements for a variety of services including construction, demolition, abatement, and the services of design professionals. These services are provided to clients involved in both private and public commercial projects in New Jersey and New York.

Mr. Preziosi graduated from Washington and Lee University (B.A. 1988) and Seton Hall Law School (J.D. 1991), where he was a member and associate editor of the *Seton Hall Law Review*. Mr. Preziosi is a member of the bars of the Supreme Court of New Jersey, the United States District Court for the District of New Jersey, and the United States Court of Appeals for the Third Circuit. He is also member of the Construction Law Section of the New Jersey Bar Association.

Ms. Jonaitis is a 2002 *cum laude* graduate of Seton Hall Law School. She was inducted into the Order of the Coif in 2004. Ms. Jonaitis received her undergraduate degrees, *cum laude*, from the University of Massachusetts in 1999, with a B.A. in communications and a B.S. in communication disorders. Ms. Jonaitis is admitted to practice in New Jersey and New York, as well as before the U.S. District Courts for the District of New Jersey, the Southern, Eastern and Western Districts of New York, and the U.S. Court of Appeals for the Third Circuit. Ms. Jonaitis is active in the National Association of Women in Construction and the New Jersey and Mercer County bar associations. She currently serves as a trustee for the Mercer County Bar Foundation.

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