

The "Tools At Hand" Fail To Get The Job Done: The Court Of Chancery Denies Request Of Hedge Fund To Inspect Books And Records

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Thursday, November 30, 2006 --- The right of stockholders to inspect the books and records of a corporation upon the showing of a proper purpose is a longstanding right recognized in Delaware law, codified and expanded in the 1967 revision of the General Corporation Law of the State of Delaware in Section 220 (Section 220).

Among the proper purposes for seeking inspection of books and records (other than the company's stock list) are to value the stockholder's equity holdings, to investigate the independence of directors, to test the veracity of the company's public disclosures and to investigate possible mismanagement or self dealing. See Donald J. Wolfe & Michael A. Pittenger, *Corporate and Commercial Practice in the Court of Chancery*, § 8-6[e] (2006).

The use of Section 220 demands and litigation arising from those demands increased after the Delaware Supreme Court's decisions in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993) and *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996).

In *Rales* and *Grimes*, the Delaware Supreme Court strongly encouraged stockholders to improve their pleadings by using Section 220 as a means of conducting a pre-suit investigation of the claims they intend to bring.

Since these decisions, the Delaware Supreme Court and Chancery Court both have strongly encouraged stockholders to make use of Section 220. The Delaware Legislature furthered this favorable environment by amending Section 220 to make it easier for stockholders to satisfy the procedural requirements of the statute, including allowing beneficial holders (rather than the record holder as required by the prior version of the statute) to make a demand for inspection on the company.

Notwithstanding this favorable environment for stockholder inspection, the Court of Chancery recently refused to order production of the documents sought by a stockholder pursuant to Section 220. *Polygon Global Opportunities Master Fund v. West Corporation*, 2006 WL 2947486 (Del. Ch. Oct. 12, 2006). In *Polygon*, West Corporation (West) announced on May 31, 2006, a proposed recapitalization resulting in a squeeze out merger.

Immediately after the recapitalization was announced, the plaintiff, Polygon Global Opportunities Master Fund (Polygon), a hedge fund that invests in event arbitrage situations, made its first investment in West common stock. Polygon continued to accumulate West common stock and by the time of trial Polygon owned West common stock worth approximately \$157 million.

About one month later, Polygon made its initial demand pursuant to Section 220. This demand was refused by West on the basis that it did not comply with the technical requirements of Section 220 and failed to state a proper purpose.

Polygon promptly made a second demand which met the technical requirements of Section 220, but West refused that demand as well. Polygon offered to narrow its demand, but West refused Polygon's offer. Polygon filed suit promptly thereafter.

In its lawsuit, Polygon alleged that it sought the documents for three proper purposes under Section 220 - to value its shares to determine whether to seek appraisal; to investigate corporate mismanagement and breaches of fiduciary duties by the board and its controlling stockholders; and to communicate with other stockholders to encourage them to seek appraisal.

The court began its analysis by noting that even if the technical requirements of Section 220 are satisfied and the plaintiff's purpose is found to be proper, the scope of the inspection should be limited to those documents "necessary, essential and sufficient to the stockholder's purpose." *Id.* at *3 (quoting *Marathon Partners, L.P. v. M & F Worldwide Corp.*, 2004 WL 1728604, at *4 (Del. Ch. July 30, 2004)). The court then determined that Polygon had a proper purpose in valuing its stock for appraisal.

Despite determining that Polygon had stated a proper purpose, the court declined to order production of the documents sought by Polygon for this purpose. The court noted that public filings with the Securities Exchange Commission (the SEC) typically provide stockholders with significant financial information. In the case of a going-private transaction, as contemplated by West here, SEC Rule 13e-3 requires "even more comprehensive" financial information be made publicly available. *Id.* at *4.

The court concluded that between West's preliminary and final proxy statements, along with the schedules required by Rule 13e-3, West "would appear to have disclosed all material information necessary for Polygon to determine whether or not to seek appraisal" and thus declined to compel West to produce the valuation documents sought by Polygon. *Id.*

The court emphasized, however, that it was not creating a per se rule that Rule 13e-3's disclosure requirements always provide stockholders with the "necessary, essential and sufficient" information to satisfy Section 220.

In this case, however, West's public disclosures - which included all presentations made to the board and special committee by the financial advisors and detailed descriptions of the financial advisors' fairness opinions; company projections; detailed descriptions of the board and specialRule 13e-3's disclosure requirements always provide stockholders with the committee meetings at which the recapitalization was discussed and terms of the controlling stockholders' investment in the surviving entity - satisfied any obligation under Section 220 to disclose all facts material to determine whether to demand appraisal.

The court then found that Polygon did not have a proper purpose to investigate potential corporate mismanagement in connection with the Recapitalization. The court found that Polygon could not pursue a derivative claim because it would not have standing to pursue a derivative action based on any potential breaches of fiduciary duty that occurred before it purchased its West common stock.

Likewise, Polygon could not pursue a direct claim based on the entire fairness of the transaction because Delaware has "a public policy against the 'evil' of purchasing stock in order to 'attack a transaction which occurred prior to the purchase of the stock.'" *Id.* at *5 (quoting *Omnicare, Inc. v. NCS Healthcare, Inc.*, 809 A.2d 1163, 1169 (Del. Ch. 2002)).

The court explained that "[t]o permit Polygon additional information to attack a transaction when it purchased stock knowing of the proposed transaction, indeed because of it, would be contrary to Delaware public policy." *Id.*

Because the court denied Polygon's requests for documents relating to valuation and investigating mismanagement, the court determined that Polygon would have nothing to discuss with other stockholders, so its third purpose for inspection was moot.

What can companies defending actions brought pursuant to Section 220 take from the decision in Polygon?

First, although the court clearly limited its holding to the facts of the case, the decision in Polygon opens the door for firms to defend against Section 220 demands on the basis that the information already disclosed by the company pursuant to various public disclosure requirements (SEC, New York Stock Exchange Regulations, etc.) satisfies the company's obligations under Section 220.

Whether this defense is available, and, if so, its effectiveness, will be specific to the purpose for which the stockholder seeks inspection. In Polygon, the stockholder sought inspection for the purpose of valuing its shares to determine whether to seek appraisal or accept the consideration offered in the recapitalization.

Naturally, the SEC's public disclosure requirements go a long way in making available to its stockholders the financial information relevant to this decision. There may be, however, certain categories of information not required to be disclosed by SEC or other regulatory rule, but still "necessary, essential and sufficient," such that a company may not be able to avoid completely the production of documents, but may substantially limit the scope any production required.

In other words, public disclosure obligations may relieve the company of a substantial of portion of the obligations under Section 220 but cannot necessarily be relied upon to avoid the obligations entirely.

Further, if the purpose of the inspection is to obtain information not ordinarily or already contained within required public filings, such as information relating to the independence of directors or to investigate potential mismanagement, then a company may not be able to rely on the information contained in its public filings to avoid inspection of documents pursuant to Section 220 for a purpose other than valuation of shares.

Second, the Polygon opinion also sends a strong message that while the Court of Chancery views Section 220 as an important stockholder tool, the court will not permit Section 220 to be abused by an opportunistic stockholder seeking leverage in a manner contrary to Delaware public policy.

In Polygon, the court found that because Polygon purchased stock in West because of the recapitalization, it would be against Delaware public policy to then allow Polygon to utilize Section 220 to obtain additional information to attack it. *Id.* at *5; see also *Highland Select Equity Fund, L.P. v. Motient Corp.*, 906 A.2d 156, 167 (Del. Ch. 2006) (denying in total Section 220 demand made by a stockholder mounting a proxy contest because, among other things, the plaintiff "appears to have maintained its books and records demand in large part because it has derived utility from the demand itself as a rhetorical platform.").

Accordingly, activist or opportunistic investors may utilize Section 220, but the public policy of Delaware limits the extent to which Section 220 can be used aggressively to pursue the individual goals of these investors and this same public policy may serve as the basis for a defense against such demands.