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Tips for Dealing with Inspection Demands

Inspection demands are the canary in the coal mine. They almost invariably foreshadow shareholder litigation. Be prepared with a strategy when they arrive.

By Mark R.S. Foster and Ryan Keats – December 10, 2019

Inspection demands made by shareholders are on the uptick. These demands play an early and significant role in shareholder litigation involving companies and their directors and officers. Shareholders make inspection demands to obtain key corporate documents before the commencement of litigation. Shareholders often seek these documents to support claims for breaches of fiduciary duty against corporate officers and directors. This article provides some practical guidance on dealing with inspection demands.

What Inspection Demands Are and Why They Are Made

While it is a given that important documents may be produced in discovery during the course of litigation, it may be a surprise to some lawyers and business leaders that potential adversaries can access key corporate documents before litigation even begins. Shareholders can obtain these documents by propounding demands to inspect corporate books and records, a right codified in most states' corporation's codes.

Courts have encouraged shareholders to pursue inspection demands before filing their lawsuits. The reason is simple: Courts expect substantiated allegations of wrongdoing, not conclusory or vague claims. Inspection demands provide a relatively inexpensive way for shareholders (and their lawyers) to obtain internal documents in litigation to try to meet the heightened pleading burdens that apply in shareholder litigation.

What a Proper Inspection Demand Looks Like

Inspection demands usually come as letters sent by a shareholder's lawyer. There are around two dozen plaintiffs' firms that are regularly active in this area of the law. The most frequently invoked inspection statute is section 220 of the Delaware General Corporations Law. That statute allows shareholders to inspect books and records for a "proper purpose." Under Delaware law, it does not matter how many shares the demanding shareholder owns (though some states sensibly impose a threshold ownership requirement to deter frivolous or abusive inspection demands).

A proper purpose to inspect records can be to value shares, to communicate with other shareholders, or to investigate potential wrongdoing or potential mismanagement. When seeking to inspect corporate documents to investigate wrongdoing or mismanagement—the most commonly invoked reason for inspection—the shareholder must provide proof of stock ownership. That proof must show stock ownership as of the time of the inspection demand and throughout the period of suspected wrongdoing. In addition, the shareholder must articulate and provide some evidence that supports a "credible basis" for suspecting wrongdoing.

The "credible basis" standard has been described by courts as the lowest possible burden of proof. Shareholders have satisfied the credible basis standard by pointing to news articles discussing problems or other adverse corporate events. In some cases, the test is satisfied by pointing to litigation against the company, government inquiries, or other publicly available

information about corporate challenges. An inspection demand predicated on potential mismanagement or wrongdoing is often a precursor to shareholder litigation against directors and officers of a corporation for alleged breaches of fiduciary duty or violation of other laws, including state and federal securities laws.

If a proper purpose for inspection is established, shareholders are entitled to inspect relevant corporate documents. The type and scope of corporate records subject to inspection will depend on the circumstances and must be "narrowly tailored" to the stated purpose of inspection. The types of documents usually subject to inspection include board minutes and related board materials, such as board presentations and reports. Given the relative ease by which board-level materials may be obtained by shareholders, extra care must be given to the preparation of these documents, as discussed further below.

Beyond board-level documents, there have been some instances in which courts have required production of other types of documents. For example, some courts have ordered production of emails from directors and officers, particularly where board materials do not provide enough insight about relevant decision making or oversight on a particular matter at issue. Other types of corporate records also have been subject to inspection, including correspondence with government agencies, as well as internal reports underlying and relating to public disclosures to investors.

Responding to an Inspection Demand

Inspection demands are often sent by mail or courier addressed to the chief executive officer or the board chair. Unfortunately, these demands sometimes get lost, overlooked, or processed long after receipt. That can be problematic. That is because, under Delaware law, a shareholder need only wait five business days for a response to a board demand before filing a lawsuit to compel production of documents. As a practical matter, most attorneys representing demanding shareholders prefer to negotiate and will wait longer than five days to initiate a lawsuit. Nevertheless, silence may be construed as a refusal and lead to precipitous litigation that is avoidable. A court might look negatively on a failure to respond and infer that it reflects poorly on internal corporate controls. To avoid an inspection demand being missed inadvertently, it is important to have policies and practices in place to make sure regular mail to key executives and directors is reviewed daily and timely processed internally. Educate appropriate staff about these types of demands to make sure that they are on the lookout and know what to do with them when they are received.

When an inspection demand is received, two steps should be taken: respond and assess.

Upon receipt of a demand, an acknowledgment of receipt should be sent promptly, usually no later than five business days after receipt of the inspection demand. A prompt response signals that the corporation is taking the demand seriously and can forestall the filing of precipitous litigation. If the shareholder does not provide proof of stock ownership with the demand letter, the acknowledgment letter should request that it be provided. Proof of ownership is essential, and the company should avoid the burdensome effort of finding and producing documents to a person who has no right to them. The acknowledgment letter should state that the demand is

being reviewed and that a substantive response will be provided promptly after that review is complete.

An assessment of an inspection demand should usually be done in consultation with litigation counsel who is familiar with securities litigation and can recommend a strategy and plan of action. That analysis may require some factual investigation. Strategic considerations should focus on whether to comply with the demand, negotiate over the scope of the demand, or litigate the purposes or scope of the demand (or both). At the outset, always check to see if there is applicable insurance coverage. Some directors' and officers' (D&O) insurance policies include coverage for inspection demands. Where there is coverage, work with the insurance broker to provide notice to the appropriate carriers.

When inspection is sought to investigate possible wrongdoing or mismanagement, the appropriate strategy in responding to the demand will often turn on a few factors, including (1) the nature of the allegations and whether they are substantiated; (2) the underlying facts, circumstances, or transactions at issue; and (3) the litigation risk. The litigation risk should be analyzed both as to the risks arising from the inspection demand itself and those that may arise if the shareholder files a complaint using the documents obtained. It is important to consider the likelihood that the demand is a precursor to litigation (either by the demanding shareholder or by others), or whether it follows related and previously filed litigation (for example, a consumer class action, product liability suit, employment case, or antitrust suit) or comes in the wake of adverse news about the company that is likely to lead to litigation or a government investigation.

It is appropriate for a company to deny an inspection demand either in full or in part where the shareholder's demand does not provide appropriate proof of stock ownership, when the demand does not offer a credible basis for inferring wrongdoing, or where the demand is overbroad in the scope of documents demanded. In most cases, it is prudent to try to negotiate an appropriate production of narrowly tailored documents. When that is not possible, or when the allegations are completely unsubstantiated, then assuming the risk of litigation over the demand may be a company's best option. Some shareholders will walk away when an inspection demand is refused. Others will go to court.

Litigation to Enforce an Inspection Demand

A shareholder may commence litigation to compel production of documents when the demand is refused or when there is an impasse in discussions about the appropriate scope of a document production. Litigation to enforce an inspection demand is limited to the demand and is completely separate from litigation relating to the merits of any claims of wrongdoing or mismanagement.

If the inspection demand is made under section 220, the shareholder must file a lawsuit in the Delaware Court of Chancery to enforce the demand. The Delaware Court of Chancery typically aims to hold "trials" on section 220 demands within 60 to 90 days from the filing of a complaint. The trials are always held before a judicial officer, not a jury. In most situations, a trial on an inspection demand will resemble a motion-to-compel hearing.

Limited discovery into the shareholder's purpose for the demand and the types of responsive documents that exist is typically permitted in advance of the trial. In some cases, a small number of depositions may be taken. Before trial, each party will submit its respective position in pretrial briefs to the court. Typical trials on section 220 actions last a few hours and are more akin to oral arguments than full trials, but in some cases, witness or expert testimony may be offered. Decisions are frequently issued from the bench at the conclusion of the trial, though in some cases more detailed written decisions are issued, typically within 90 days after the trial's conclusion. Trials on inspection demands are never an adjudication on the underlying merits of alleged wrongdoing, though preliminary comments about the merits may be offered by the court and could frame or shape the perception of the merits of any litigation going forward. That is a risk that should be carefully weighed when deciding whether or not to refuse an inspection demand.

Producing Documents in Response to an Inspection Demand

When producing documents in response to a demand, several customary conditions to production should be considered. In almost all circumstances, production will be conditioned on the negotiation of a confidentiality agreement that adequately safeguards the information produced. Courts also have allowed companies to condition production on shareholder agreement to a forum selection provision that requires any subsequent litigation relating to the subject matter of the demand to be commenced in a specified forum, often the Delaware Court of Chancery. That condition is particularly helpful for companies that have not yet adopted forum selection clauses in their corporate charters or bylaws. Companies may also condition production of documents on a shareholder's agreement that any produced documents can be used by the company (or its directors and officers) in support of a motion to dismiss any claims subsequently asserted by the shareholder. This condition—which explicitly incorporates all produced documents in a shareholder complaint by reference—prophylactically serves to prevent "cherry-picking" by shareholders when they assert claims in a complaint. This condition helps give the court full context when adjudicating motions to dismiss.

All documents produced in response to an inspection demand should be reviewed for not only responsiveness but also privilege. This is especially important given that board materials often contain privileged information. Privileged portions of responsive documents are typically redacted before production. Portions of responsive documents that are irrelevant to the issues in the demand are also often redacted.

Board Materials Should Be Prepared Thoughtfully

Given the relative ease and frequency with which board materials are produced in connection with inspection demands, it is important that these documents be prepared with an eye toward future litigation. The board materials should serve as a robust record of directors' diligence and good faith. This type of evidence is particularly helpful in ensuring that directors' decisions are entitled to the protection of the business judgment rule.

Unfortunately, too many companies spend too little time preparing minutes that provide meaningful protection for their directors. Often, minutes look more like agendas with a lot of boilerplate terms such as "discussion ensued, a motion was made, and the board resolved as

follows." A lack of necessary detail can have negative ramifications. For example, when sparse materials are produced in response to inspection demands, shareholders are more likely to be permitted access to a broader scope of documents, including other internal reports and emails. To minimize that risk, board materials should be self-contained and provide enough detail to convey a coherent and compelling story of board deliberation. The absence of sufficient details in board materials also might be construed adversely by a court in litigation. If there is little or no discussion about a matter in the board minutes, a court might conclude that the board of directors did not adequately inform themselves or otherwise adequately discharge their fiduciary duties.

There is no magic formula for determining the appropriate level of detail for board minutes, but any summary should show that there was thorough discussion about the pertinent subject, identify the main facts and issues considered, note any advisors or company officers relied on for advice, and reflect that the company's best interests were considered. Board materials should also cross-reference the materials provided to the board so that there is a record of what was provided and considered. If any directors discussed the issue outside of the meeting, that too is worth noting as it augments the evidence of good faith and due care exercised by the directors.

Frequently, important substantive information in board minutes is attributed to lawyers, raising possible privilege issues. Ideally, not all of the substantive discussions reflected in board minutes will be attributed to lawyers. That way, there is substantive discussion in the board materials that is not redacted, which should minimize the risks of scope creep and adverse inferences by a court discussed above. While the attorney-client privilege is still sacrosanct, there are exceptions that allow shareholders to obtain access to even privileged attorney-client communications, particularly where there are not better ways for shareholders to obtain access to the information they seek. As a result, be mindful that not all privileged communications are invariably beyond the reach of shareholders.

Finally, board materials should be compared to public statements about related topics. What is said internally should match what is said externally. If there is a disconnect, there should be a good reason for it and that reason should be documented. If there is not a good reason, steps should be taken to investigate and remediate.

Concluding Thoughts

Inspection demands are often the canary in the coal mine. They almost invariably foreshadow litigation. Given the relatively quick timelines associated with inspection demands, it is important to review and respond with care. That often requires preparing a litigation strategy (and, in some cases, a public relations strategy) on a short fuse, mindful of the risks on the horizon. Be prepared.

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