

King v. VeriFone Holdings, Inc.:
Demand for Corporate Records to Replead Dismissed Federal Derivative Action Not a
“Proper Purpose” Under Delaware General Corporation Law § 220

Section 220 of the Delaware General Corporation Law gives a corporation’s shareholders the right to inspect the corporation’s books, records and other specified financial information for any “proper purpose.”¹ The Delaware Court of Chancery is granted the “exclusive jurisdiction” to determine whether a proper purpose exists and whether the shareholder is entitled to the information sought. The question presented to the Chancery Court in *King v. VeriFone Holdings, Inc.*² was whether a shareholder’s desire to obtain information to remedy a complaint deemed defective in another proceeding constitutes a proper purpose under § 220. The court held that it does not.

I. Facts and Procedural History

In November 2006, VeriFone Holdings, Inc. acquired Lipman Electronic Engineering Ltd. On December 3, 2007, VeriFone announced that it needed to restate its financial statements for the first three quarters of fiscal year 2007 due to accounting errors that arose during the integration of Lipman’s inventory systems into its own. This announcement led to an SEC investigation, ultimately culminating in the SEC filing a civil complaint against VeriFone.

After VeriFone’s December 3 announcement, various shareholders, aided by their attorneys, quickly instituted derivative action suits against VeriFone alleging that they suffered damages when VeriFone’s stock price dropped following the announcement. Charles King, who at the time owned 3000 shares of VeriFone stock, won what the court deemed the “filing Olympics” - meaning he was the first to file suit - and was granted lead plaintiff status. King’s attorney admits that she “rapidly filed the complaint on his behalf . . . in order to have the first derivative complaint on file and therefore to be the winner in the lead counsel Olympics race.”³ As the court noted, “winning that race came at an eventual price.”⁴

Although King was the first to file, he and his counsel “did not undertake any responsible pre-suit investigation” into the legitimacy of his claims.⁵ And since King alleged in his complaint that the board of directors had failed to comply with its oversight responsibilities under *Caremark*,⁶ King faced a high pleading burden.⁷ VeriFone quickly challenged the complaint’s sufficiency. In October of 2008, eleven months after submitting his initial complaint, King moved to amend his complaint to cure any previous defects; however, King did not seek to obtain further information from the defendants through discovery. As noted by King’s attorney, any such request for discovery would not have been granted given Federal Rule of Civil Procedure 23.1’s

¹ For a full list of a shareholders rights and privileges under § 220, *see* 8 Del. C. § 220(b), (c).

² *King v. VeriFone Holdings, Inc.*, 2010 WL 1904972 (Del. Ch. 2010).

³ *Id.* at *3.

⁴ *Id.*

⁵ *Id.*

⁶ *In re Caremark Int’l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

⁷ For a more in-depth discussion of the current pleading standard *see Bell Atl. Corp. v. Twombly*, 127 S. Ct. 1955 (2007), *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009).

mandate that a derivative plaintiff may not obtain discovery until her pleading burden showing grounds for demand excusal is met.

The Federal Court dismissed King's amended complaint. But rather than dismissing the complaint with prejudice, the District Court granted King leave to once again amend his complaint, even suggesting that King utilize § 220 to obtain the facts required to establish demand futility.

King served VeriFone with a books and records demand letter on June 9, 2009. VeriFone provided King with approximately 1,350 pages of documents concerning the Lipman acquisition and the audit committee's oversight of its integration, but refused to provide King with the audit committee report that summarized the committee's review of the integration process, citing that these documents were privileged. The parties attempted to mediate the dispute; however, when mediation failed, King initiated a § 220 action in the Delaware Chancery Court. King stated that his purpose in examining the books and records was to help him plead a viable claim for demand excusal in the pending derivative action in Federal Court. Simultaneously, King submitted another amended complaint to the District Court where dismissal briefing had again commenced.

II. The Chancery Court's Decision

The Chancery Court chose not to address VeriFone's claim that the withheld materials were privileged, finding instead that the documents need not be produced since King failed to state a proper purpose for viewing the materials under § 220.

Resting its decision on *Beiser v. PMC-Sierra, Inc.*, a 2009 Delaware Chancery Court decision in which an untimely § 220 action was judged to have no proper purpose,⁸ the court gives three main reasons for finding that no proper purpose exists in this instance: (1) using § 220 in this manner would undermine Federal Rule of Civil Procedure 23.1, (2) filing a § 220 action "in order to get discovery in another court conflicts with the well-established and sensible policies against subjecting defendants to simultaneous suits in separate forums,"⁹ and (3) allowing King to use § 220 in an "after-the-fact" manner incentivizes plaintiff's attorneys to participate in the "filing Olympics," a charade the court finds to be inefficient and a waste of scarce judicial resources.

Federal Rule of Civil Procedure 23.1 prevents plaintiffs in derivative action suits from obtaining discovery until they have successfully pled grounds for demand excusal.¹⁰ Like in *Beiser*, the information requested by King would not have been discoverable in King's derivative action suit since his complaint had already been deemed insufficient by the District Court. King was attempting to circumvent this rule by bringing a § 220 action in a court 2,500 miles away from his derivative suit in California. Given King's stated purpose for obtaining VeriFone's books and records, a finding of proper purpose in the § 220 action would serve to subvert the purpose of 23.1, and that, according to the *King* court, should not be allowed.

The Chancery Court also discussed the policy implications of King's § 220 action. First, the court notes the inefficiencies that arise when cases are instituted in this manner. King filed his § 220 action over eighteen

⁸ In *Beiser* no proper purpose was found given (1) Plaintiff filed his § 220 action nearly two years after bringing his derivative claim in another court, and (2) "attempting to obtain discovery for use in a case where such discovery is clearly prevented by federal law, without more," cannot be a proper purpose under § 220. See *Beiser v. PMC-Sierra, Inc.*, 2009 WL 483321, at *3-4.

⁹ *King*, 2010 WL 1904972 at *6.

¹⁰ As a corollary, discovery may not be used to supplement allegations of demand futility. See *In re Merck & Co., Inc. Sec., Deriv. & ERISA Litig.*, 493 F.3d 393, 400 (3d Cir. 2007).

months after filing his initial derivative action suit. During that eighteen-month period King subjected VeriFone to costly litigation that could have been avoided if King and his attorney had investigated first and filed second. Additionally, filing in this “after-the-fact” manner subjected VeriFone to costly litigation in two separate forums, a practice which “wastes scarce judicial resources through repetitive litigation, and exposes the corporation and its shareholders to unnecessary additional defense costs.”¹¹ Vice Chancellor Strine articulates that, in order to prevent these inefficiencies, plaintiffs should generally seek to use the § 220 tool prior to initiating any other litigation.¹²

Finally, the court considers how allowing King to prevail in his § 220 action would serve to rouse the “perverse incentives” that motivate plaintiff’s attorneys to quickly file derivative action suits prior to launching an investigation into the financial documents of the corporation. King’s desire to quickly file his derivative action suit was solely to obtain lead plaintiff and lead counsel status. The court makes it clear, however, that “the intended end of the derivative lawsuit is not furthering the interests of fast filing plaintiffs or their lawyers.”¹³ Rather, the derivative action tool should be used to further the corporation’s best interests. Granting King’s § 220 request would be antithetical to that end since it would require VeriFone to expend funds that would be put to better use elsewhere on defending multiple lawsuits in multiple fora.

III. Significance of the Decision

The *King* decision emphasizes that the shareholders’ right to inspect books and records pursuant to § 220 of the Delaware General Corporation Law is restricted to inspection for a proper purpose, which may not include the use of § 220 to shore up a defective derivative action claim in another jurisdiction.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

¹¹ *King*, 2010 WL 1904972 at *6.

¹² *See also Beiser*, 2009 WL 483321, at *3.

¹³ *King*, 2010 WL 1904972 at *6.