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Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions

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USING STATE INSPECTION STATUTES FOR DISCOVERY IN FEDERAL SECURITIES FRAUD ACTIONS

RANDALL S. THOMAS AND KENNETH J. MARTIN*

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ABSTRACT

We propose that plaintiffs in securities fraud actions should use state inspection statutes to obtain discovery about potential securities fraud cases. First, we argue that the Private Securities Law Reform Act has substantially increased shareholders' difficulty in uncovering securities fraud. Next, we show that shareholders have an alternative method of investigating fraud: state inspection statutes. We then analyze cases filed under the Delaware inspection statute to examine the costs to plaintiffs of pursuing claims under this statute. We find that the statutory inspection process is a largely successful, although expensive and time-consuming, process. Nevertheless, potential plaintiffs could realize substantial benefits from utilizing inspection statutes in this manner, particularly if Delaware streamlined its inspection process to make it faster and less costly for shareholders seeking information.

INTRODUCTION AND OVERVIEW¹

In 1995, Congress enacted the Private Securities Litigation Reform Act ("Reform Act" or "PSLRA")² in an effort to curtail the perceived misuses by professional plaintiffs of the private securities litigation process.³ The Reform Act was designed to cut back on the number of securities fraud lawsuits filed by private investors by: raising the pleading requirements for these suits; placing stringent restrictions on class action filings by certain shareholders; increasing potential sanctions against plaintiffs and their lawyers for filing frivolous securities suits; and imposing a stay of all discovery if the defendant company files a motion to dismiss the action.⁴

Just as Congress intended, these new rules will discourage plaintiffs from filing poorly pled, weak fraud cases or will hasten their early dismissal at a lower cost to the defendants. Unfortunately, by making it much more difficult for plaintiffs to litigate securities fraud class actions, PSLRA will also have the effect of eliminating some meritorious lawsuits

¹ This article is the companion to *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331 (1996), by Randall S. Thomas. That article focuses on the use of state inspection statutes in derivative actions. The two articles overlap in certain areas, primarily where they discuss state law issues and the empirical results presented in this article.

² Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

³ See H.R. CONF. REP. NO. 104-369, at 31 (1995) ("The private securities litigation system is too important to the integrity of the American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits.").

⁴ See *infra* Parts I.A.-D. for further discussion of these provisions of the Reform Act.

that would otherwise deter securities fraud or punish wrongdoers.⁵

How should a plaintiff with a legitimate securities fraud case proceed in the face of the Reform Act? Under the new law, the plaintiff will need to plead fraud with particularity without obtaining any nonpublic information from the defendants.⁶ Undoubtedly, some plaintiffs will be able to satisfy the heightened requirement that they state facts sufficient to establish a strong inference that the defendants acted with scienter—that is, with intent to defraud—without resort to the discovery process.⁷ In most cases, however, only in the unusual circumstance where the defendants have disclosed these facts in their own federal securities filings, or in the course of an ongoing federal investigation, would information sufficient to satisfy the pleading requirements become publicly available.⁸ Plaintiffs with potentially legitimate securities fraud grievances who lack sufficient hard evidence of fraud will need to look elsewhere to inquire further into potential claims.

We suggest that shareholders who are potential plaintiffs in securities fraud actions use state inspection statutes to obtain more information to substantiate potential securities fraud claims before filing a class action lawsuit.⁹ Shareholders seeking to investigate potential fraud have a statutory right to access the company's internal files under state corporate law.¹⁰ If the shareholders can establish a "credible possibility" of fraud

⁵ See John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 354 (1995) (noting that the Reform Act raises "concerns that some good cases may be thrown out with the bad"); Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996) (arguing that civil securities fraud lawsuits play a critical role in deterring fraud and improving capital market efficiency).

⁶ The Congressional Conference Report to PSLRA makes it clear that Congress wanted to "strengthen existing pleading requirements" beyond those previously required under the most stringent standards. H.R. CONF. REP. NO. 104-369, at 41. "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." *Id.* at 48 n.23.

⁷ For an argument that the new pleading requirements may have little effect on plaintiffs' ability to plead adequately a securities fraud case, see Elliott J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675, 683 (1996) (claiming that the Reform Act's pleading requirement reasonably could be read as creating a standard so high "that plaintiffs would find it virtually impossible to satisfy," but concluding that the courts will not adopt this interpretation).

⁸ Investors in nonreporting companies do not receive mandatory disclosures. In many cases, however, these investors are more actively involved in the management of their investment and have access to better information about potential wrongdoing.

⁹ We recognize that in some cases, such as where the federal statute of limitations is about to expire, plaintiffs may need to file simultaneously both actions.

¹⁰ See, e.g., DEL. CODE ANN. tit. 8, § 220 (1991). For further discussion, see *infra* Part II.B.

and state a proper purpose, state inspection statutes permit a court to give them access to those corporate books and records that relate to the alleged fraud.¹¹ After reviewing the relevant documents, the shareholders will be able to determine if they should pursue a federal or state remedy, or, if they do not believe that fraud has occurred, drop any further litigation plans.

Shareholders also may wish to contact other investors about potential fraud at the company to learn if they wish to join in a legal action. State inspection statutes entitle any shareholder to learn the identities of all other shareholders by obtaining a "stocklist" from the corporation.¹²

In cases where the corporation believes that the shareholders' request has been made in good faith and the company has nothing to hide, management may choose to provide the requested documents without a fight. In some circumstances, however, corporate management will refuse the shareholders' demand for books and records or the stocklist. If so, the shareholders can seek legal redress by filing suit in state court to force production of the information.¹³ If the shareholders comply with the stat-

¹¹ The "books and records" of the corporation include: appropriate corporate accounting records; minutes of all meetings of the corporation's shareholders, board of directors or its committees, or of actions taken by written consent by the shareholders or board of directors; the stocklist materials; and copies of the corporation's certificate of incorporation, bylaws, written communications to shareholders, and resolutions creating one or more classes of stock. *See* MODEL BUS. CORP. ACT § 16.01 (1994) (describing the records that should be kept by a corporation); *see also* DEL. CODE ANN. tit. 8, § 224 (1991) (including stocklist, books of account, and minute books as records). In some books and records cases where the plaintiffs have alleged corporate misconduct, the courts have given them much broader access. *See infra* notes 95-102 and accompanying text.

¹² A stocklist consists of a list of record shareholders with their names and addresses, as well as subsidiary information such as magnetic tape compilations, breakdowns of stockholding by depository nominees—commonly referred to as CEDE breakdowns—and, where appropriate, lists of non-objecting beneficial owners of stock held by registered brokers and dealers that are available to the issuer under Rule 14b-1, 17 C.F.R. § 240.14b-1 (1996), (the "NOBO list"), and its counterpart for banks that hold stock for consenting beneficial owners under Rule 14b-2, § 240.14b-2, (the "COBO list"). For further discussion, see EDWARD ARANOW ET AL., *PROXY CONTESTS FOR CORPORATE CONTROL* § 3 (forthcoming 1997).

¹³ The corporate laws of every state provide shareholders with the statutory right to inspect a corporation's stocklist and books and records. The Delaware statute expressly provides that "[a]ny stockholder [of record] . . . shall, upon written demand under oath . . . have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records." DEL. CODE ANN. tit. 8, § 220(b) (1991).

If the corporation fails to produce the requested documents, the shareholder has the right to file suit in state court to compel their production. Delaware law allows a stockholder to sue to compel inspection if its written demand is refused or not answered within five business days. *See* § 220(c). The proceeding is a summary pro-

utory formalities and state a proper purpose for obtaining the documents,¹⁴ a court generally will order the company to produce information that is "necessary and essential" to achieve the shareholders' purpose.¹⁵

In this article, we examine the feasibility of shareholders using state inspection statutes as pre-filing discovery vehicles in potential securities fraud actions. After exploring the legal requirements for pursuing such action, we look at the likely costs and benefits to plaintiffs forced to litigate these issues. We use data from cases filed under the Delaware inspection statute¹⁶ in the Delaware Chancery Court during the period 1981-1994.

Our analysis reveals that plaintiffs obtained a stocklist in nearly 80% of the cases included in our sample,¹⁷ while they obtained books and records in about two-thirds of the cases included in the sample.¹⁸ The median time for a successful litigant to obtain the stocklist through the court was slightly over one month (three months for books and records), while the unsuccessful litigant in a stocklist case waited a median period of over two months (nine months for books and records).¹⁹ Both types of litigation appear to be costly.²⁰

Based on these data and our analysis of the legal issues, we conclude that state inspection statutes are a viable and potentially useful discovery mechanism for prospective plaintiffs in securities fraud actions. Although stockholders using such statutes must bear additional expense to determine if they have a case worth pursuing, the corresponding benefits ap-

ceeding with an accelerated schedule for discovery and trial. The court has plenary jurisdiction to grant all necessary relief. *See generally* 2 ERNEST L. FOLK, III ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 220 (1993) (providing commentary and analysis).

¹⁴ The general rule is that a stockholder is entitled to inspection only for a proper purpose; that is, for a lawful and reasonable purpose germane to his status as a stockholder. *See FOLK, supra* note 13, at § 220.7. This requirement allows the court to balance the requesting stockholder's interest in obtaining information against the corporation's interest in protecting itself and other shareholders from harmful or disruptive inspections. *See id.*

The burden of proof in establishing a proper purpose lies with the shareholder when the shareholder is seeking to obtain books and records. *See infra* notes 87-88 and accompanying text. Where the shareholder wants to get a stocklist, however, the corporation has the burden of showing that the shareholder's stated purpose is improper. *See infra* notes 109-10 and accompanying text.

¹⁵ *See, e.g.,* Thomas & Betts Corp. v. Leviton Mfg. Co., 681 A.2d 1026, 1035 (Del. 1996) (affirming the Court of Chancery's decision to limit plaintiff's inspection to "those documents which are essential and sufficient" to the plaintiff's purpose).

¹⁶ DEL. CODE ANN. title 8, § 220 (1991).

¹⁷ *See infra* Part III.B.

¹⁸ *See infra* Part III.C.

¹⁹ *See infra* Parts III.B.-C.

²⁰ *See id.*

pear to outweigh the costs. They will experience an improved success rate in the cases they file, an increased likelihood of early settlement, and lower costs as a result of pursuing fewer weak cases that courts eventually will dismiss. However, if Delaware wants to improve the ability of shareholders of its corporations to obtain the necessary information to detect securities fraud, it should revise its inspection statute to make it less costly and faster for plaintiffs to use for discovery purposes.

In Part I we discuss those provisions of the Reform Act that adversely affect private securities fraud plaintiffs by making it more difficult to pursue securities fraud litigation. In Part II we discuss the availability of state inspection statutes, particularly that of Delaware, as a mechanism for pre-litigation discovery. In Part III we discuss the costs, both in time and money, of using the Delaware inspection statute to obtain information. In Part IV we discuss some of the reasons why potential securities litigation plaintiffs have not rushed to use inspection statutes for pre-suit discovery. We conclude by noting that Delaware can make its inspection statute a more effective discovery device by amending it to provide, for example, for quicker trials and attorney fee awards against unjustifiably recalcitrant defendants.

I. PRIVATE SECURITIES LITIGATION REFORM ACT PROVISIONS THAT ADVERSELY AFFECT PRIVATE SECURITIES FRAUD LITIGANTS

The Reform Act contains four provisions that will discourage many investors from pursuing securities fraud class actions. First, the Act raised the pleading standard for securities fraud suits brought under the Securities Exchange Act of 1934 ("Exchange Act").²¹ Second, the Act requires discovery to be stayed during the pendency of a motion to dismiss a securities fraud complaint.²² Third, the Act places restrictions on the actions of "professional plaintiffs" and class counsel.²³ Finally, the Act makes it easier for defendants to seek and obtain sanctions against plaintiffs and their counsel for violations of Rule 11 of the Federal Rules of Civil Procedure.²⁴ The cumulative effect of these new restrictions is to raise significantly the bar for pursuing a successful securities fraud action.²⁵

²¹ See *infra* Part I.A.

²² See *infra* Part I.B.

²³ See *infra* Part I.C.

²⁴ See *infra* Part I.D.

²⁵ The Reform Act contains several other important provisions that are not the focus of this article, including: safe harbor provisions for forward-looking statements; limitations on recoverable damages; changes to defendants' proportionate liability and settlement rights; exclusion from the RICO statute of securities fraud as a predicate act; and revised auditor reporting obligations. For an in-depth discussion of these aspects of PSLRA, see Avery, *supra* note 5, at 354-78. We recognize that these other

A. Heightened Pleading Requirements for Securities Fraud Complaints

Rule 9(b) of the Federal Rules of Civil Procedure (“FRCP”) requires plaintiffs claiming securities fraud (or any other type of fraud) to state their allegations with particularity.²⁶ In enacting the Reform Act, Congress made clear its belief that the FRCP’s pleading requirement was unsuccessful in deterring private litigants from abusing the federal securities laws.²⁷ Congress determined that a “uniform and more stringent pleading requirement[] [was needed] to curtail the filing of meritless lawsuits.”²⁸

To achieve its objective, Congress decided that a federal securities fraud complaint must: (1) specify each statement alleged to have been misleading and the reasons why the statement was misleading, and (2), if an allegation is made on information and belief, state with particularity all facts upon which that belief was formed.²⁹ Furthermore, the complaint must state with particularity facts giving rise to a strong inference that the defendant acted with the requisite scienter, or intent to defraud, with respect to each alleged wrongful act or omission.³⁰ This latter requirement codifies a pleading standard for state of mind that is based on the Second Circuit’s case law, a standard which is generally regarded as the most stringent pleading requirement among the federal circuits.³¹

Congress did not expressly define the requisite state of mind that needs to be pled for securities fraud liability. The initial bill introduced in the House of Representatives in 1995 would have precluded liability based

changes will also reduce the incentives that class counsel has to pursue potential claims under the federal securities laws.

²⁶ See FED. R. CIV. P. 9(b) (requiring that allegations of fraud or mistake be stated with particularity, while malice, intent, knowledge, and other conditions of mind may be averred generally.).

²⁷ See H.R. CONF. REP. NO. 104-369, at 41 (1995) (noting that Rule 9(b) has not succeeded in preventing abuse of the securities laws). President Clinton attempted to stop the passage of the Reform Act with his veto power, stating that the pleading requirement would “impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts.” *Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States*, H. DOC. NO. 104-150, 104th Cong., 1st Sess. (Dec. 19, 1995), reprinted in 141 CONG. REC. H15214-06, available in 1995 WL 752858. The President’s concern was that the pleading barrier would be so high that aggrieved shareholders with serious losses would be unable to pursue their claims. See *id.*

²⁸ H.R. CONF. REP. NO. 104-369, at 41.

²⁹ See *id.*

³⁰ See *id.*

³¹ See *id.* (adopting explicitly the Second Circuit’s “most stringent” pleading standard, but refusing to codify the Second Circuit’s case law interpreting it); see also Avery, *supra* note 5, at 357 (noting that the Reform Act codified a standard for pleading state of mind that is based on the Second Circuit’s test, “generally regarded as the most stringent used today”).

on reckless conduct in actions for damages under section 10(b) of the Exchange Act.³² This bill was subsequently amended to allow liability based on reckless conduct, following the standard that had been adopted by most of the federal appellate courts.³³ In the Reform Act as adopted, Congress avoided endorsing any standard of liability for securities fraud cases and intentionally omitted any implication that recklessness is sufficient to establish civil liability.³⁴

The Reform Act requires courts to dismiss complaints that do not meet the new pleading standards.³⁵ Plaintiffs attempting to flesh out their pleadings can file discovery requests seeking additional information from defendants. However, unless the court finds discovery necessary to preserve evidence or prevent undue prejudice, all discovery is stayed if the defendant files a motion to dismiss the case.³⁶ If the complaint is dismissed, the new legislation requires the court to make specific findings about the factual and legal basis for the complaint to determine if the defendant is entitled to an award of attorneys' fees and costs.³⁷

B. *Stay of Discovery*

In most federal litigation, the plaintiff requests documents and deposi-

³² See Avery, *supra* note 5, at 369.

³³ See *id.* at 370 (describing the Seventh Circuit's standard for a reckless omission as an "extreme departure from the standards of ordinary care" (quoting *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977))). As SEC Chairman Arthur Levitt pointed out while testifying before Congress in 1995, the recklessness standard assures the markets of a continuous stream of accurate information and provides corporations with incentives "to conduct a full inquiry into areas of potential exposure." *Id.* at 370 n.236 (quoting *Securities Litigation Reform Proposals—S.240, S.667 and H.R.1058: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong. 247 (1995) (testimony of Arthur Levitt, Chairman, SEC)). An actual knowledge standard, by contrast, would "virtually foreclose recovery against lawyers, accountants, and financial advisers," thereby reducing such professional advisers' efforts to encourage full and complete disclosure. *Id.*

³⁴ See *id.* at 370-71 & n.237; *cf.* Weiss, *supra* note 7, at 680 & n.33 ("I assume that to satisfy the requirements of [the Reform Act] in an action under Rule 10b-5, a plaintiff must state with particularity . . . facts that give rise to a strong inference that the defendant acted with some degree of intent to deceive or defraud."). Ultimately this question will need to be addressed by the Supreme Court, which has previously reserved decision on the matter. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983); *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976).

³⁵ See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101, 109 Stat. 737, 747 (1995) (codified in scattered sections of 15 U.S.C.).

³⁶ See *id.*

³⁷ See *id.* at 742, 748.

tions after filing its complaint and meeting with the other party.³⁸ If the defendant chooses to file a motion to dismiss, it may simultaneously file a motion to stay discovery pending the court's determination of the dispositive motion.³⁹ The court has discretion in deciding whether to grant this motion.⁴⁰

The Reform Act removes the court's discretion, requiring it to stay discovery during the pendency of a motion to dismiss a securities fraud complaint brought under the Securities Act of 1933 ("Securities Act") or the Exchange Act.⁴¹ Those defendants who obtain a dismissal will benefit from greatly reduced litigation costs. For plaintiffs, however, the change means that in most cases they must seek evidence of fraud without the assistance of the court.

C. Measures to Restrict Class Actions

In theory, class action lawsuits improve judicial handling of actions brought by large numbers of plaintiffs, each with small claims.⁴² The class action mechanism allows for the aggregation of multiple claims into a single action with potential efficiencies in the discovery and trial processes.⁴³ In the securities field, however, Congress concluded that a class of "professional plaintiffs" was manipulating the system and that reforms were needed.⁴⁴

The Reform Act contains a number of provisions designed to alleviate this perceived problem. First, each named plaintiff in an action must certify, *inter alia*, that she did not purchase the security at the request of her attorney in order to participate in the lawsuit.⁴⁵ Second, each plaintiff must publish a notice of the pendency of the action in a national business publication or wire service.⁴⁶ Third, any class member can apply to be

³⁸ See FED. R. CIV. P. 26(a), (d), (f) (allowing for discovery requests after the parties have met to plan the time and form of discovery).

³⁹ See FED. R. CIV. P. 26(c).

⁴⁰ See *id.*

⁴¹ See § 101(a)-(b), 109 Stat. at 738, 747. The sole exception to this rule is where the court finds that the discovery is needed to preserve evidence or to prevent undue prejudice to a party. See *id.* (stating that all parties are required to preserve all documents that are relevant to the allegations of the complaint during the pendency of the motion to dismiss and the stay of discovery). If the motion to dismiss is denied, and the parties have failed to preserve all documents, there may be disputes over what documents were relevant and therefore required to be preserved.

⁴² See *Avery, supra* note 5, at 371 (noting that critics of the private litigation system have expressed concern that the current system is open to abuse).

⁴³ See *id.* (emphasizing the "powerful deterrent effect" of the class action).

⁴⁴ See H.R. CONF. REP. NO. 104-369, at 32 (1995) (stating that the House and Senate committee hearings demonstrated the need to reform the legislation to curtail the efforts of "professional plaintiffs").

⁴⁵ See § 101(a)-(b), 109 Stat. at 738, 743.

⁴⁶ See *id.*

appointed lead plaintiff, and there is a rebuttable presumption that the class member with the largest financial interest is the most adequate lead plaintiff.⁴⁷ Fourth, the Reform Act prohibits any bounty payments or other bonuses to named plaintiffs.⁴⁸ Fifth, the Reform Act discourages courts from allowing a person to be a lead plaintiff in more than five securities fraud cases during any three-year period.⁴⁹ Finally, the Act authorizes the courts to require plaintiffs to post bonds for payment of the fees and expenses of the defendant.⁵⁰

These provisions undoubtedly will discourage plaintiffs' attorneys from rushing to file poorly drafted complaints with little investigation and without client consultation. To the extent that they reduce the incentives for small stockholders and entrepreneurial counsel to ferret out securities fraud, however, they will also cut back on the policing of the capital markets.

D. Sanctions for Rule 11 Violations

Sanctions, properly applied, can deter frivolous litigation.⁵¹ Prior to the Reform Act, courts had two principal sources of discretionary power to sanction litigants of meritless lawsuits. First, section 11(e) of the Securities Act authorizes a court to assess costs and reasonable attorneys'

⁴⁷ See *id.* at 738-39, 743-44. This provision is designed to improve the oversight of class counsel by the named plaintiffs by making the shareholder with the greatest financial interest in the litigation the lead plaintiff and by eliminating the "race to the courthouse." See H.R. CONF. REP. NO. 104-369, at 34 (stating that this requirement will encourage "the most capable" representation). Another member of the purported plaintiff class can rebut this lead plaintiff presumption only by showing that this individual will not adequately protect the interests of the class or is subject to unique defenses that render him an incompetent representative. See § 101, 109 Stat. at 739, 744-45.

A few courts have already entered orders permitting institutional investors with substantial holdings to become lead plaintiff or co-lead plaintiff in securities fraud actions. See, e.g., Dean Starkman, *Fund Displaces Law Firm to Lead Cellstar Lawsuit*, WALL ST. J., Oct. 2, 1996, at B9; Dean Starkman, *Calpers Wins a Lead Role in Suit Over Grace's Severance Packages*, WALL ST. J., Sept. 12, 1996, at B12 (detailing a state court's order that an institutional investor be given a place as co-lead counsel in settlement talks in a derivative action).

⁴⁸ See § 101, 109 Stat. at 740, 745 (requiring that any settlement be dispersed equally to all class members, including the lead plaintiff, on a per share basis).

⁴⁹ See *id.* (stating that a person may be lead plaintiff in no more than five securities class actions during any three-year period, except as a court may otherwise permit).

⁵⁰ See *id.* at 746. The Reform Act contains numerous other provisions that will reduce the incentives for filing these actions. The most prominent of these changes caps a court's award of attorney fees and expenses to class counsel at a "reasonable percentage" of the amount actually paid to the class. *Id.* at 740, 745.

⁵¹ See Avery, *supra* note 5, at 358-60 (discussing the efficiency of sanctions to deter frivolous lawsuits without deterring meritorious suits).

fees against the plaintiff if it determines that a suit is meritless.⁵² Second, Rule 11⁵³ of the FRCP permits a court to sanction an attorney for filing a document containing legal contentions that are unwarranted by existing law and that lack a nonfrivolous argument for the extension, modification, or reversal of an existing law, or the establishment of new law.⁵⁴ The courts occasionally have applied these sanctions in securities fraud cases.⁵⁵

The Reform Act requires courts to make specific findings concerning each party's and attorney's compliance with the Rule 11 requirements.⁵⁶ If the court finds that there has been a violation of Rule 11, it is required to impose sanctions.⁵⁷ If the violation occurs in a responsive pleading or dispositive motion, the presumptive sanction is the reasonable attorneys' fees and expenses incurred by the opposing party as a direct result of the violation.⁵⁸ If the complaint "substantially fails" to comply with Rule 11, the presumptive sanction is the total amount of the opposing party's attorneys' fees and expenses for the entire action.⁵⁹

E. *The Effects of the Reform Act on Securities Fraud Complaints*

As Congress intended, the Reform Act raises serious procedural and substantive obstacles for a potential plaintiff in a securities fraud action.⁶⁰ As outlined above, a plaintiff will need to have strong, well documented evidence of fraud before it files a securities fraud action.⁶¹ Investors can

⁵² See Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (1994). The Exchange Act does not contain an equivalent provision.

⁵³ FED. R. CIV. P. 11 (requiring that at least one attorney sign all documents, listing the occasions under which attorneys can face sanctions, and explaining the nature of those sanctions).

⁵⁴ See *id.*

⁵⁵ See Avery, *supra* note 5, at 359 & n.170 (citing examples).

⁵⁶ See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101, 109 Stat. 737, 742, 747-48 (1995) (codified in scattered sections of 15 U.S.C.) (providing for mandatory sanctions).

⁵⁷ See *id.* at 742, 748.

⁵⁸ See *id.* This sanction can be avoided in two instances: (1) if the party or attorney shows that this award would impose an unreasonable burden and would be unjust, and that the failure to impose the award would not impose a greater burden on the opposing party; or (2) if the violation was *de minimis*. See *id.* In those instances, the court has discretion to impose whatever sanctions it deems appropriate pursuant to Rule 11 of the FRCP. See *id.*

⁵⁹ See *id.*; see also Avery, *supra* note 5, at 360 (discussing this provision of the Reform Act). This heightened presumptive sanction is, however, afforded the same possibility for rebuttal as other violations. See *supra* note 58 for a description of the rebuttal evidence necessary to defeat the presumption.

⁶⁰ See H.R. CONF. REP. NO. 104-369, at 32 (1995) (stating that this "legislation implements needed procedural protections to discourage frivolous litigation").

⁶¹ Plaintiffs' counsel appear to be relying more on evidence of potential insider

no longer file a "bare bones" fraud complaint and then rely on the discovery process to obtain substantiating evidence. Shareholders now will think twice about filing a securities fraud complaint on the mere suspicion of fraud. If they decide to file a complaint, they risk dismissal for failure to meet the heightened pleading standards and may face Rule 11 sanctions for bringing what appears to the court to be a frivolous lawsuit.

The Reform Act's high pleading standards and tight discovery limitations will ensure that only strong securities fraud claims will survive a motion to dismiss and move into the discovery process. These standards, however, also exact a cost: courts will dismiss potentially valid actions where the publicly available evidence of fraud is insufficiently strong. Investors need a mechanism to investigate potential securities fraud complaints in cases where there is some evidence that fraud has occurred, but not enough to meet the strict pleading requirements of the Reform Act.

Congress has determined that the direct and indirect costs to securities fraud defendants of using the standard discovery process in civil litigation outweigh the benefits to the plaintiffs and the public.⁶² There may be alternative discovery mechanisms for plaintiffs, however, that would provide them access to internal corporate documents to investigate fraud claims. In the next two Parts, we examine the availability, utility, and costs of state corporate law inspection statutes as an alternative discovery method in securities fraud cases.

II. STATE INSPECTION STATUTES AS A DISCOVERY DEVICE IN FRAUD CASES

Securities fraud is only one variety of corporate fraud. Shareholders are concerned about any fraud that could adversely affect the value of their investment. If they believe that corporate fraud is occurring, and corporate management is uncooperative about responding to their concerns, shareholders can seek redress under state or federal law. State law fraud claims can be either derivative or direct, depending on the nature of the alleged injury.⁶³

trading to meet the Reform Act's standards. See Vanessa O'Connell, *Lawyers Scan Insider Sales to Build Suits*, WALL ST. J., June 5, 1996, at C1 ("Lawyers who specialize in suing companies whose stock prices drop increasingly are using insider sales to help build class-action securities-fraud suits.").

⁶² See H.R. CONF. REP. NO. 104-369, at 37 (calling discovery in securities class actions "fishing expeditions," and noting that some testimony estimated that discovery costs accounted for 80% of total litigation costs in securities fraud cases).

⁶³ See *Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996) (granting motion to dismiss in a derivative action and stating that the distinction between an individual and a derivative claim depends on the nature of the harm and potential relief). The *Grimes* court noted that the distinction between a direct claim and a derivative claim has been articulated frequently by the courts, although it is difficult to apply in practice. See *id.* To state an individual claim, the plaintiff must state a claim which is separate and

In a derivative action, the shareholder sues on behalf of the corporation for harm done to the corporation.⁶⁴ The claim belongs to the corporation, and the corporation—through its board of directors—must make a decision whether to assert the claim.⁶⁵ The plaintiff, therefore, is required either to make a pre-suit demand on the board to take action to remedy the alleged wrongdoing or to state with particularity why it need not demand board action (i.e., plead “demand futility”).⁶⁶ If the plaintiff makes a demand on the board, then the plaintiff concedes that demand is required and can only regain control of the litigation by establishing that the board wrongfully refused the demand.⁶⁷

To establish demand futility, or that their demand was wrongfully refused, plaintiffs in a derivative action must allege particularized facts that

distinct from that suffered by other shareholders, or which implicates a contractual right of the plaintiff that exists independently from any right of the corporation. *See id.*

⁶⁴ *See* ROBERT CHARLES CLARK, CORPORATE LAW § 15.1, at 639 (1986) (describing a shareholder’s derivative suit as an “accountability mechanism[] for large formal organizations”). The suit can be conceptualized as two actions combined into one: (1) a suit in equity against the corporation seeking an order compelling it to bring (2) a suit for relief against a third party, often an officer or director, who caused legal injury to the corporation. *See id.*

⁶⁵ *See id.* at 640-41 (stating that the decision to sue is ordinarily a matter for the business judgment of directors).

⁶⁶ *See Grimes*, 673 A.2d at 1216 (stating this “basic principle” of corporate governance). Plaintiffs generally prefer to claim that demand is futile so as to retain control over the litigation. If they make demand on the board of directors to take action, the board will control the future proceedings in the case. *See id.* at 1220 (stating that a plaintiff can no longer claim that demand is excused after making a demand on the board). Frequently the board will decide not to pursue the litigation, refuse the shareholders’ demand, and move to dismiss the complaint in a demand-required case. *See, e.g., Levine v. Smith*, 591 A.2d 194, 208 (Del. 1991) (involving board moving to dismiss derivative claim after refusing demand by shareholder).

⁶⁷ *See Grimes*, 673 A.2d at 1216, 1218-19 (noting that the plaintiff retains the right to claim wrongful refusal of the demand). To establish a wrongful refusal of demand by the board, the shareholder must allege with particularity facts creating a reasonable doubt that the board acted independently or with due care in responding to the shareholder’s demand. *See id.* at 1219. If the shareholder establishes a wrongful refusal of demand, the shareholder has the same right to bring the action that would exist if a court had excused demand as futile. *See id.*

The *Grimes* court stated that for purposes of investigating the board’s actions in refusing demand, the plaintiff cannot use the normal discovery processes under the rules of civil procedure. *See id.* at 1218 n.22. However, in the same opinion, the court stressed that the plaintiff still has the right to use the “tools at hand,” such as the inspection statute, to obtain “the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused.” *Id.* at 1218.

create a reasonable doubt that either: (1) a majority of the board is independent for purposes of responding to the demand or refusing the demand⁶⁸ or (2) the challenged action is protected by the business judgment rule.⁶⁹ These pleading requirements aim to deter baseless lawsuits by screening out weak cases where the plaintiffs' claims are based largely on the mere suspicion of wrongdoing.

While deterrence of baseless lawsuits is a laudable goal, the courts are (or should be) concerned that this screen will block legitimate lawsuits that would remedy actual wrongdoing. Plaintiffs with an otherwise strong case may need a method of getting nonpublic corporate information in order to meet the pleading requirements for demand futility. They cannot use the normal discovery procedures to fully investigate corporate mismanagement or fraud unless the court finds that they have made allegations of wrongdoing sufficient to establish demand futility or wrongful refusal.⁷⁰ However, they frequently cannot allege particularized facts sufficient to satisfy the court and obtain discovery in a derivative action without first examining internal corporate documents.⁷¹ Thus, the plaintiffs in a derivative suit frequently lose if the defendant files a motion to dismiss.

Shareholders seeking evidence of potential securities fraud could turn to state inspection statutes to aid discovery. For this approach to succeed, the shareholders would need to have some basis for their fraud claim and

⁶⁸ Alternatively, the plaintiff could allege that even if the board is independent, a majority of the board is incapable of *acting* independently for some other reason, such as being dominated and controlled by an interested party. *See id.* at 1216.

⁶⁹ *See id.* at 1217 (stating that the requirement will help to create a balanced environment which protects valid suits but prevents baseless claims). Under the business judgment rule, courts presume that corporate directors are informed and act in good faith to serve the best interests of the company. *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (placing the burden on the challenging party to rebut this presumption). In wrongful refusal cases, the court must determine whether there is a reasonable doubt that the board acted with due care in refusing the shareholder's demand. *See Grimes*, 673 A.2d at 1219.

⁷⁰ As a general matter, plaintiff shareholders under existing Delaware law have no right to discovery for the purpose of substantiating the allegations of their complaint. *See, e.g.,* Levine, 591 A.2d at 208-10. Instead, they must rely on publicly available information, such as media reports or company SEC filings. *See* Rales v. Blasband, 634 A.2d 927, 934 n.10 (Del. 1993) (reminding plaintiffs that, even though they do not have the right to discovery, they may use the media and government agencies to gather information). This limitation has made it difficult for plaintiffs to survive a motion to dismiss. *See, e.g.,* Grimes, 673 A.2d at 1210 (dismissing claim because plaintiff failed to state with particularity why the board's refusal to act was wrong); Levine, 591 A.2d at 214-15 (dismissing plaintiff's complaint for failure to plead particularized facts).

⁷¹ *See supra* note 69.

allege a proper purpose for inspection of corporate information.⁷² Below, we explore the use of inspection statutes, particularly that of Delaware, to meet the particularized pleading requirements of derivative suits.

A. *Derivative Lawsuits and the "Tools at Hand"*

The idea that the Delaware inspection statute⁷³ ("section 220") should be used as a discovery device in shareholder *derivative* actions was first proposed by the Delaware Supreme Court in *Rales v. Blasband*.⁷⁴ The *Rales* court stated that "[s]urprisingly, little use has been made of section 220 as an information-gathering tool in the derivative context."⁷⁵ The court proposed that shareholders seek to use section 220 as a pre-filing discovery device in cases alleging director misconduct.⁷⁶ In a subsequent decision reaffirming *Rales*, the Delaware Supreme Court alluded to this use of section 220, reminding plaintiffs to use the "'tools at hand' to obtain the necessary information before filing a derivative action."⁷⁷

Section 220 gives derivative suit plaintiffs a means of pre-filing discovery that potentially could reduce the incidence of poorly pled derivative suits. Using section 220 in this manner would lessen the problems faced by these plaintiffs in responding to motions to dismiss. An additional advantage is that cases filed under the inspection statute are expedited.⁷⁸

B. *Using State Inspection Statutes in Potential Securities Fraud Cases*

Shareholders face heightened pleading requirements under the Reform Act that are analogous to those in derivative actions. If they do not allege particularized facts to support a claim of fraud, the court will dismiss

⁷² See *Compaq Computer Corp. v. Horton*, 631 A.2d 1, 3-4 (Del. 1993) (stating that a proper purpose is one reasonably related to the stockholder's interest in the corporation and not adverse to the company).

⁷³ DEL. CODE ANN. tit. 8, § 220 (1991) (giving stockholders the right to inspect, for any proper purpose, the corporation's stock ledger, list of stockholders, and other books and records). For discussion of the Delaware inspection statute, see *supra* note 13.

⁷⁴ 634 A.2d 927, 934 n.10 (Del. 1993) (encouraging disgruntled plaintiffs to seek out new sources of information to meet the pleading requirement).

⁷⁵ *Id.*

⁷⁶ See *id.*

⁷⁷ *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996) (footnote omitted). The *Grimes* court extensively quoted from the *Rales* decision on this point. See *id.* at n.11.

⁷⁸ See *Estate of Polin v. Diamond State Poultry Co.*, No. 6374, 1981 WL 7612, at *2 (Del. Ch. Apr. 14, 1981) (deciding that a shareholder's right to inspect books and records under section 220 of the Delaware Corporate Code is virtually absolute once a proper purpose is shown). A shareholder who demands inspection is not precluded from enforcing her right simply because she has another suit pending against the corporation and could obtain the same books and records through discovery. See *id.* (rejecting the argument that plaintiff's right to inspect should be barred once she files a complaint and initiates discovery).

their complaint.⁷⁹ Furthermore, in the typical case, shareholders will be unable to use the normal discovery techniques to resist a motion to dismiss.⁸⁰ Instead, they must use other methods to obtain information or rely exclusively on public information to investigate securities fraud.

If, after analyzing all publicly available information, shareholders have strong reasons to believe that fraud or similar wrongdoing has occurred, but insufficient information to proceed with a securities fraud complaint or take other appropriate action, they could bring an action under the state inspection statute to obtain additional necessary information.⁸¹ As described below, the rules differ slightly depending on whether shareholders are requesting books and records or a stocklist.

Shareholders seeking to uncover suspected wrongdoing by corporate management have a statutory right under Delaware's corporate inspection statute to examine the company's "books and records."⁸² At a minimum, the "books and records" of a corporation include: corporate accounting records; minutes of all meetings of the shareholders, board of directors, and board committees; records of actions taken by written consent of the shareholders or board of directors; stocklist materials; the corporation's certificate of incorporation; corporate bylaws; written communications to shareholders; and copies of resolutions creating one or more classes of stock.⁸³ "Books and records" may also include documents relating to allegedly wrongful transactions.⁸⁴

⁷⁹ See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 101(b), 109 Stat. 737, 747 (1995) (codified in scattered sections of 15 U.S.C.) (providing for dismissal if pleading requirements are not met). For further discussion of the heightened pleading requirements of the Reform Act, see *supra* Part I.A.

⁸⁰ See § 101(a)-(b), 109 Stat. at 741, 747 (providing for stay of discovery while any motion to dismiss is pending). For further discussion of the stay of discovery under the Reform Act, see *supra* Part I.B.

⁸¹ See *Everett v. Hollywood Park, Inc.*, No. 14556, 1996 Del. Ch. LEXIS 2, at *10 (Del. Ch. Jan. 19, 1996) (observing that plaintiff engaged expert to analyze publicly available information, then filed action to compel production of books and records concerning alleged mismanagement and self-dealing transactions by corporate management).

⁸² See MODEL BUS. CORP. ACT § 16.02(a) (1994) ("A shareholder of a corporation is entitled to inspect and copy . . . any of the records of the corporation . . ."); *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026, 1031 (Del. 1996) ("It is well established that investigation of waste and mismanagement is a proper purpose for a Section 220 books and records inspection.").

⁸³ See *Thomas*, *supra* note 1, at 333 n.11 (citing MODEL BUS. CORP. ACT § 16.01 (1991)); see also DEL. CODE ANN. tit. 8, § 224 (1991) (listing stock ledger, books of account, and minute books as records maintained by a corporation in the regular course of business).

⁸⁴ See *Everett*, 1996 Del. Ch. LEXIS 2, at *19-20 (permitting inspection of all documents examined by a special litigation committee that reviewed same claims in litigation in another state); *Holdgreiwe v. Nostalgia Network, Inc.*, No. 12914, 1993 Del.

Any shareholder of record of a Delaware corporation, upon written demand and statement of a proper purpose, has the right to inspect the corporation's stocklist and other books and records.⁸⁵ If the corporation refuses to permit inspection or fails to respond to the shareholder's request, the shareholder may seek a court order compelling allowance of inspection.⁸⁶ To obtain such an order, the shareholder must establish that he made a proper demand for the information and must state a proper purpose for seeking the information.⁸⁷ The shareholder seeking books and records bears the burden of establishing that the stated purpose is proper.⁸⁸

A stated purpose could include inspecting the company's books and records to determine if fraud or corporate mismanagement is occurring, even if an action is pending against the company.⁸⁹ This purpose would be proper even if the inspection would lead to an increased damage award in the pending lawsuit, because a company has no legitimate interest in avoiding payment of any compensatory damages owed to its owners.⁹⁰ However, the shareholder's purpose cannot be adverse to the corporation's legitimate interests.⁹¹

Ch. LEXIS 71, at *20-21 (Del. Ch. Apr. 29, 1993) (ordering inspection of "detailed financial data, stock transfer books, tax information, intra-corporate communications, correspondence regarding potential investment in Nostalgia by third parties, press releases, and communications and filings with securities regulators").

⁸⁵ See DEL. CODE ANN. tit. 8, § 220(b) (1991) (outlining the procedure for making a written request to a company for access to its stocklist and other books and records).

⁸⁶ See § 220(c) (establishing the Court of Chancery's jurisdiction to order inspection).

⁸⁷ See *id.* (requiring that the plaintiff establish compliance with procedural requirements and a proper purpose); see also *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 685 A.2d 702, 708 (Del. Ch. 1995) (noting that a shareholder must "make a demand under oath that states a purpose reasonably related to its interest as a shareholder"), *aff'd*, 681 A.2d 1026 (Del. 1996).

⁸⁸ See § 220(c) (setting out requirements); see also *Thomas & Betts*, 685 A.2d at 709 ("Where the subject of the demanded inspection are [sic] the corporation's books and records (as distinguished from its stockholder list), the shareholder has the burden of establishing a proper purpose.").

⁸⁹ See *Compaq Computer Corp. v. Horton*, 631 A.2d 1, 4 (Del. 1993) (finding that inclusion of more plaintiffs in pending litigation would not substantially increase the company's costs of defending the litigation).

⁹⁰ See *id.* In *Compaq Computer*, the plaintiff requested a stocklist in order to "solicit the participation of other shareholders in legitimate non-derivative litigation against the defendant corporation." *Id.* at 2. The plaintiffs sought *individual damages* for alleged acts of fraud and mismanagement. See *id.* Thus, a plaintiff seeking to recover individual damages for securities fraud violations should be able to rely on *Compaq Computer* to rebut any claim that investigating such fraud is an improper purpose.

⁹¹ See *Thomas & Betts*, 685 A.2d at 709. Absent exceptional circumstances, it is

Where the shareholder seeks to investigate suspected waste or mismanagement, it must "adduce evidence from which a credible possibility" of such misdeeds may be inferred.⁹² However, "[w]hile stockholders have the burden of coming forward with specific and credible allegations sufficient to warrant a suspicion of waste and mismanagement, they are not required to prove by a preponderance of the evidence that waste and mismanagement are actually occurring."⁹³ If the shareholder satisfies these requirements, the court will grant access to those books and records that are "essential and sufficient for the stockholder's purposes."⁹⁴

The Delaware courts have held that the scope of inspection should be broad where a shareholder is investigating possible corporate mismanagement.⁹⁵ In *Everett v. Hollywood Park, Inc.*,⁹⁶ the plaintiff offered specific evidence showing a "pattern of waste and mismanagement" in several apparently self-dealing transactions involving the company's Chairman of the Board.⁹⁷ After deciding that the plaintiff had established her right to examine the corporation's books and records, the court struggled to determine the proper scope of discovery.⁹⁸ The court ultimately allowed the plaintiff access to all books and records that the company had previ-

not enough for the corporation to claim an interest in maintaining the confidentiality of its financial information. *See id.* (noting that the risk will not normally bar the statutory inspection right). A confidentiality agreement may be enough to address a corporation's privacy concerns, absent compelling circumstances. *See id.* at 710.

⁹² *See Everett v. Hollywood Park, Inc.*, No. 14556, 1996 Del. Ch. LEXIS 2, at *13 (Del. Ch. Jan. 19, 1996) (noting that a plaintiff investigating possible mismanagement or waste has a higher evidentiary burden to obtain books and records); *Thomas & Betts*, 685 A.2d at 710 (concluding that hearsay evidence was insufficiently reliable to state a proper purpose for obtaining books and records to investigate possible waste and mismanagement).

⁹³ *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026, 1031 (Del. 1996).

⁹⁴ *Everett*, 1996 Del. Ch. LEXIS 2, at *19; *Thomas & Betts*, 685 A.2d at 714 (stating that courts must construe narrowly a shareholder's right to inspect books and records so as to provide only those records that are essential and sufficient).

⁹⁵ *See Skoglund v. Ormand Indus., Inc.*, 372 A.2d 204, 211 (Del. Ch. 1976) (concluding that the right of inspection should not be limited to those transactions that aroused plaintiffs' suspicions, but should extend to the general records generated during the period into which plaintiffs sought to inquire); *Holdgreiwe v. Nostalgia Network, Inc.*, No. 12914, 1993 Del. Ch. LEXIS 71, at *20 (Del. Ch. Apr. 29, 1993) ("If Mr. Holdgreiwe's inspection of Nostalgia's records is to effectuate its purpose of enabling him to determine whether management wrongdoing has occurred, his access to Nostalgia's records must necessarily be broad and unrestricted."); *cf. Security First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 570 (Del. 1997) (noting that discovery in an inspection case involving management "should result in an order circumscribed with rifled precision").

⁹⁶ No. 14556, 1996 Del. Ch. LEXIS 2 (Del. Ch. Jan. 6, 1995).

⁹⁷ *Id.* at *9.

⁹⁸ *See id.* at *20 (noting the extreme nature of the scope of inspection proposals by both sides).

ously made available to a special litigation committee formed by the company in derivative litigation involving the same transactions.⁹⁹

A Delaware court also granted broad discovery in *Holdgreiwe v. Nostalgia Network, Inc.*¹⁰⁰ In that case, a corporate director alleged that the CEO and Chairman had misappropriated company funds. The court found that the plaintiff had established a proper purpose to examine the corporate books and records.¹⁰¹ It proceeded to give the plaintiff "broad and unrestricted" access to corporate information.¹⁰²

Investors also may want to communicate with fellow shareholders about their investigation and potential litigation that may arise from it. Certain types of shareholders, such as institutional investors, have their own organizations and can easily communicate with fellow members.¹⁰³ Otherwise, shareholders must rely on public information, which will provide the names of only some shareholders.¹⁰⁴ State inspection statutes, however, entitle shareholders to obtain a "stocklist" from the corporation, from which shareholders may learn the identities of *all* their fellow shareholders.¹⁰⁵

A shareholder can demand a stocklist from the corporation.¹⁰⁶ If management refuses the demand, the shareholder can sue in state court to force production.¹⁰⁷ The shareholder must establish compliance with

⁹⁹ *See id.* (finding the documents given to the special litigation committee "essential and sufficient" for inspection in the present case because they involved the same transactions). That litigation was filed in California one week before the Delaware plaintiff's initial demand and one week after the Delaware action began. *See id.* at *2-3. Within two business days of the filing of the California case, the parties had agreed in principle to a settlement. *See id.* at *3. Following the execution of that agreement, the company appointed a special committee of its directors to investigate the allegations of the California complaint, and it reviewed the company's books and records. *See id.* at *3-4. The special committee ultimately recommended that the company enter into the proposed settlement, subject to approval of its fairness by a California court. *See id.*

¹⁰⁰ No. 12914, 1993 Del. Ch. LEXIS 71, at *20 (Del. Ch. Apr. 29, 1993) (granting plaintiff "broad and unrestricted" access to defendant company's records).

¹⁰¹ *See id.* at *10 (finding a proper purpose in obtaining information to determine whether management had mismanaged the company by misappropriating funds).

¹⁰² *Id.* at *20 (allowing access to various documents, including detailed financial data, tax information, intra-corporate communications, and securities filings).

¹⁰³ *See Thomas, supra* note 1, at 331-32 (discussing internal communications networks of institutional investors).

¹⁰⁴ *See id.* at 331 (discussing limited ability of shareholder to determine identity of other shareholders through public filings).

¹⁰⁵ *See, e.g.,* DEL. CODE ANN. tit. 8, § 220(b) (1991). For further explanation of what information is included in a stocklist, see *supra* note 12.

¹⁰⁶ *See, e.g.,* § 220(b) (conferring right on a stockholder to inspect a corporation's list of stockholders upon written demand).

¹⁰⁷ *See, e.g.,* § 220(c) (allowing stockholder to apply to the Court of Chancery for an order to compel inspection).

statutory formalities in making the demand.¹⁰⁸ The burden then shifts to the company to show that the shareholder's demand lacks a proper purpose.¹⁰⁹ If the company cannot make this showing, the court should order it to produce the stocklist.¹¹⁰ The company cannot claim that communicating with other potential plaintiffs in a derivative suit is an improper purpose for a stocklist request.¹¹¹ Indeed, potential plaintiffs in a securities fraud action should be entitled to obtain a stocklist so as to communicate with fellow shareholders about joining in a lawsuit.¹¹²

The Delaware statute requires that the plaintiff seeking books and records must be a stockholder of record of the company.¹¹³ Thus, shareholders with potential securities fraud claims can not use the state inspection statute for discovery once they have sold all of their stock. Although this asymmetry may be troubling in theory, in practice the problem is not that severe. The potential plaintiff class frequently will include other investors who have retained an equity interest in the company and who can use the inspection statute to obtain the information.¹¹⁴

In short, investors who are concerned about potential corporate mismanagement or fraud and who have some evidence of wrongdoing can use state inspection statutes to dig deeper into suspect transactions. They can request books and records and a stocklist under these statutes. The remaining question is whether it makes sense for investors to pursue this approach.

¹⁰⁸ See *id.* (requiring that shareholders comply with the statutory demand procedure).

¹⁰⁹ See *id.* ("Where the stockholder seeks to inspect the corporation's stock ledger or list of stockholders . . . , the burden of proof shall be upon the corporation to establish that the inspection he seeks is for an improper purpose."); *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 685 A.2d 702, 708 (Del. Ch. 1995) ("Any doubts will be resolved in favor of the statutory inspection right."), *aff'd*, 681 A.2d 1026 (Del. 1996).

¹¹⁰ See, e.g., § 220(c) (allowing the Court of Chancery to order immediate inspection or order production of a list of shareholders on a specific date, in return for the reasonable cost of obtaining the list).

¹¹¹ See *Compaq Computer Corp. v. Horton*, 631 A.2d 1, 4 (Del. 1993) (noting that a corporation has no legitimate interest in avoiding payment of compensatory damages to its owners).

¹¹² The *Compaq Computer* court also offered an alternative rationale for its decision that the shareholder's purpose was not contrary to the company's interest: the company would be protected because it could seek indemnification from its co-defendant managers and advisors. See *id.* This rationale would apply with equal force in most securities fraud actions as well.

¹¹³ See § 220(a) (defining "stockholder" as a "stockholder of record").

¹¹⁴ See *Sadler v. NCR Corp.*, 928 F.2d 48, 51 (2d Cir. 1991) (allowing arrangement where plaintiff in stocklist action acted as agent for potential acquiring company and was reimbursed for all of its costs).

III. THE COSTS OF USING THE DELAWARE INSPECTION STATUTE

In studying the utility of state inspection statutes as a discovery device for securities fraud litigation, we have focused on the most widely used inspection statute, section 220 of the Delaware General Corporation Law.¹¹⁵ Before analyzing data on cases filed under this statute, we briefly outline the statutory process that investors must follow.¹¹⁶

The shareholder first must make a written demand on the corporation to produce the information.¹¹⁷ If the corporation fails to produce the requested information within five business days of the shareholder's written demand, Delaware law permits the shareholder to sue in the Chancery Court to compel inspection in a summary judicial proceeding.¹¹⁸ The complaint must state that the shareholder has made proper demand on the corporation and that either the required number of days has passed without the production of the requested information or the company has refused the shareholder's demand.¹¹⁹ As noted, the complaint must also state a proper purpose.¹²⁰ In order for the investigation of possible corporate fraud or mismanagement to be a proper purpose, the shareholder must allege facts sufficient to establish a "credible possibility" that such fraud or corporate mismanagement has occurred.¹²¹

The summary proceeding has a very narrow scope in a stocklist case. The shareholder may obtain an ex parte order reducing the time that the defendant has to answer the complaint and fixing an expedited trial date.¹²² Generally, the company must file its answer within ten days, and a trial date will be set for a few weeks later.¹²³ The timetable is more

¹¹⁵ DEL. CODE ANN. tit. 8, § 220 (1991).

¹¹⁶ This description is taken from a companion article by one of the authors on a related issue. For a more complete discussion of the procedures used in litigating an inspection case under the Delaware statute, see Thomas, *supra* note 1.

¹¹⁷ See § 220(b) (outlining procedures for requesting a corporation's business records). More precisely, the shareholder making the request must be a stockholder of record. See § 220(a). The shareholder may conduct the inspection personally or appoint an agent to do it. See § 220(b). Furthermore, the demand must be made under oath and delivered to the corporation's registered Delaware office or principal place of business. See *id.* The shareholder should also offer to bear the reasonable costs incurred by the company in connection with the production of the information. See Thomas, *supra* note 1, at 347 n.96.

¹¹⁸ See § 220(c) (allowing for application to the Court of Chancery for an order to compel inspection).

¹¹⁹ See *id.* (establishing a five-day limit for the company's reply and requiring that the plaintiff establish compliance with the statutory demand procedure).

¹²⁰ See *supra* notes 85-88 and accompanying text.

¹²¹ See *supra* notes 92-93 and accompanying text.

¹²² See Thomas, *supra* note 1, at 348 (describing the summary proceeding of a stocklist case).

¹²³ See *id.* (noting that this summary process can be shortened even further).

extended in a books and records case.¹²⁴

Discovery is limited in an inspection case. The defendant may depose the plaintiff, but the deposition's scope is strictly limited to establishing the validity of the plaintiff's stated demand purpose and compliance with the statute's procedural requirements.¹²⁵ Also, the defendant may ask the plaintiff to produce documents evidencing the plaintiff's stated purpose and to produce any corporate documents that the plaintiff already possesses.¹²⁶ The Chancery Court will not expand the defendant's discovery rights to cover other matters.¹²⁷

Close to the time of the hearing, the parties normally submit briefs on the merits of the inspection demand.¹²⁸ As the trial date approaches, the parties frequently choose to settle the case and file a stipulation of dismissal. If the case proceeds to trial, and the court grants the plaintiff's request, it will normally order the immediate production of the documents.¹²⁹ With this background in mind, we turn to our analysis of the data on inspection cases.

A. *Description of the Data*

We obtained our information on Delaware inspection statute lawsuits from the public court files in the Court of Chancery for New Castle County, Delaware. First, we asked the court clerk's office for a list of the cases filed and resolved by settlement or court decision from 1981-1994 under title 8, section 220 of the Delaware Code. Using this list, we searched each case file to obtain the date of the plaintiff's demand for a stocklist or books and records; the date of the outcome of the litigation; the disposition of the case by the parties or the court; the plaintiff's stated purpose in making its demand; and the number of pages of litigation papers filed by each party. We had complete information on all of these variables in ninety-one stocklist cases and fifty-three books and records

¹²⁴ *See id.*

¹²⁵ *See id.* (explaining the limited scope of a deposition).

¹²⁶ *See id.* (explaining the limited nature of document production).

¹²⁷ *See id.*

¹²⁸ *See id.* (discussing procedure of the inspection action).

¹²⁹ *See id.* However, the court frequently imposes certain conditions on the parties. These include a requirement that the shareholder be given reasonable access to the information, usually requiring that the inspection be conducted during regular business hours at the corporation's offices. *See DEL. CODE ANN.* tit. 8, § 220(b) (1991). Furthermore, in books and records cases, the court will limit its order to documents that are "essential and sufficient" to satisfy the shareholder's stated purpose. *See Thomas & Betts Corp. v. Leviton Mfg. Co.*, 685 A.2d 702, 709 (Del. Ch. 1995), *aff'd*, 681 A.2d 1026 (Del. 1996). This restriction protects the corporation's sensitive business information from disclosure and stops potential abuses by shareholders. The court may also require the shareholder to execute a confidentiality agreement before permitting access to corporate documents. *See id.*

cases; these cases constitute our final sample. Table 1 provides a breakdown of our stocklist sample by the year the complaint was filed and the outcome of the case.¹³⁰ Table 4 contains similar information for the books and records cases.¹³¹

B. *The Stocklist Cases*

Table 1 reveals that shareholders did not obtain a stocklist in about 22% of the cases¹³²—a surprisingly high number if one believes, as many Delaware lawyers do, that “plaintiffs always get a stocklist.”¹³³ Most of these failures, however, were in the context of voluntary settlements of the litigation—what we categorize as a “Dismissal Without List.”¹³⁴ We contacted the attorneys of record in these cases to determine whether a stocklist ultimately was produced to the plaintiff by the defendants. We treated those cases where we could not obtain this information as failures to obtain the stocklist and compiled them in the “Dismissal Without Further Information” category.¹³⁵

The Chancery Court denied the plaintiff shareholder’s request for a stocklist in only four of the 29 cases (14%) litigated to a decision.¹³⁶ This

¹³⁰ See *infra* tbl. 1.

¹³¹ See *infra* tbl. 4.

¹³² See *infra* tbl. 1. This number is a calculation of “Plaintiff Does Not Obtain List” cases as a percentage of the total cases in the sample.

¹³³ See, e.g., Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1, 31 (1992) (“The state courts *always* order the company to turn over the list.”).

¹³⁴ See *infra* tbl. 1. After filing a lawsuit, a plaintiff can obtain a stocklist either through a court order or through an agreement of the parties to dismiss the lawsuit. In all twenty-nine cases where a court order was entered, the order either denied the shareholder’s request (a failure) or ordered the defendant to produce the stocklist (a success). See *infra* tbl. 1. In the remaining sixty-two cases, the parties reached a voluntary settlement as a result of which the plaintiff dismissed, or the parties agreed to dismiss, the lawsuit and filed a stipulation of dismissal. See *infra* tbl. 1. This stipulation commonly states the conditions of the dismissal, which may or may not include the production of the stocklist. When the stipulation stated that the defendant would provide the stocklist to the plaintiff, we counted that as a success. If the stipulation did not provide for production of the stocklist, we counted that as a failure. We reasoned that if the dismissal required production of the information, the stipulation would set out the terms for its production. This is particularly likely to be true for books and records. Unfortunately, our definitions of success and failure may misclassify cases where the plaintiff obtained the stocklist before filing the stipulation of dismissal and did not mention the receipt of the stocklist. As we note in the text, we attempted to correct this problem by contacting the attorneys in these cases to find out if the stocklist had been produced.

¹³⁵ See *infra* tbl. 1. To avoid overstating the cases where a stocklist was obtained, we assume that the plaintiff did not obtain the requested information in these cases.

¹³⁶ See *infra* tbl. 1. This number is a calculation of “Decision Against Plaintiff” cases as a percentage of the total cases litigated to a decision.

finding generally supports the claim of some scholars that state courts invariably grant shareholder requests for stocklists.¹³⁷ Furthermore, in situations where the plaintiffs did not succeed initially, they could refile their case if its earlier defects were merely procedural.

To explore further the reasons some shareholders did not obtain a stocklist, we examined the shareholders' "proper purpose" statements; that is, why they sought to obtain a stocklist.¹³⁸ The proper purpose requirement is intended to weed out unwarranted demands by stockholders. Most of the cases in our sample that the courts dismissed were dismissed because the plaintiff failed to state a "proper purpose" for the stocklist demand.¹³⁹

In Table 2, we present a frequency distribution by outcome of shareholders' stated purposes for demanding a stocklist.¹⁴⁰ Purposes 2, 3, and 5 are concerned with shareholder communications. Collectively, they constitute 61% of the stated purposes.¹⁴¹ Those shareholders who stated one of these three purposes had a success rate of 83%,¹⁴² as compared to a success rate of 70% for shareholders stating other purposes.¹⁴³ These differences in the shareholders' rates of success in obtaining the company's stocklist, however, are not statistically significant at the 10% level of confidence.¹⁴⁴

We present in Table 3 descriptive statistics for the other variables in

¹³⁷ See, e.g., Black, *supra* note 133, at 31 (stating that courts order provision of the stocklist as a matter of course).

¹³⁸ As noted above, the "proper purpose" requirement provides that a shareholder is entitled to obtain a copy of the stocklist only for a lawful and reasonable purpose germane to his status as a shareholder. See DEL. CODE ANN. tit. 8, § 220(b) (1991); see generally FOLK, *supra* note 13, at §§ 220.7-220.7.2 (discussing how courts have approached document requests under the statute). Once the shareholder states a proper purpose for obtaining a stocklist, the company has the burden of showing that the stated purpose is improper. See *supra* text accompanying notes 106-12.

¹³⁹ In three of the four court-ordered dismissals, the court found that the plaintiff had failed to state a proper purpose. The fourth case was dismissed because of a procedural defect.

¹⁴⁰ See *infra* tbl. 2 (listing eight purposes used to obtain a stocklist and a breakdown of the results of these attempts).

¹⁴¹ See *infra* tbl. 2. This number is a calculation of the total number of times purposes 2, 3, and 5 were used as a percentage of the total number of all purposes used.

¹⁴² See *infra* tbl. 2. This number is a calculation of the total number of times "Plaintiff Obtains List" by using purposes 2, 3, and 5 as a percentage of the total number of times purposes 2, 3, and 5 were used.

¹⁴³ See *infra* tbl. 2. This number is a calculation of the total number of times "Plaintiff Obtains List" by using purposes 1, 4, 6, 7, and 8 as a percentage of the total number of times purposes 1, 4, 6, 7, and 8 were used.

¹⁴⁴ In other words, although the shareholders' success rates in obtaining the stocklist were higher when their purpose was to communicate with other shareholders, the statistical differences in success rates were not sufficiently different that we can conclude they are not due to other factors.

our stocklist sample.¹⁴⁵ Panel A gives these statistics for plaintiffs who obtained the stocklist, while Panel B lists similar information for unsuccessful plaintiffs.¹⁴⁶ Panel C provides t-statistics for differences in the variable means and Wilcoxon Z-statistics for differences in the variable medians.¹⁴⁷

DELAY, the first variable shown in Table 3, measures the days elapsed between the demand and the outcome dates.¹⁴⁸ In other words, DELAY tells us how long a plaintiff can expect to wait for resolution of its case.¹⁴⁹ DELAY indirectly measures a defendant's ability to drag out the resolution of a stocklist demand and inflict indirect costs on the plaintiff. A longer delay makes it more difficult for the plaintiff to communicate quickly with other shareholders, and thus increases the plaintiff's total costs.

Comparing Panels A and B of Table 3, we see that the median and mean delays for successful shareholders seeking stocklists are slightly more than one month and three months, respectively, while the median and mean delays for unsuccessful shareholders are about two months and over six months, respectively.¹⁵⁰ The differences between the medians and means are not significantly different.¹⁵¹

Next, we include three variables that measure the pages of litigation materials filed by the parties in inspection actions.¹⁵² We attempt to estimate the probable costs to parties of an inspection action from the number of pages of litigation materials that prior litigants of such actions have filed. Our hypothesis is that we can indirectly measure legal costs as a function of the number of pages filed.¹⁵³ We discussed our approach

¹⁴⁵ See *infra* tbl. 3. Our sample has several large outlier observations. Therefore, we believe that the median values are more informative than the mean values. We show both in the tables for completeness. See *infra* tbls. 3, 6.

¹⁴⁶ See *infra* tbl. 3.

¹⁴⁷ See *infra* tbl. 3.

¹⁴⁸ See *infra* tbl. 3.

¹⁴⁹ We define the demand date as the date of the plaintiff's written demand to the corporation to provide information (in this instance, a stocklist). We obtained this date from the plaintiff's demand letter to the corporation; the plaintiff must attach this letter to the complaint filed at the Chancery Court. We define the outcome date as follows: in cases in which the court decided in the plaintiff's favor, we used the date for production of the information. In cases in which the court decided against the plaintiff, we used the date of the court's final order resolving the demand. For settlements in favor of the plaintiff, we used the date for production of the information from the parties' stipulation of dismissal. Finally, for settlements in which the parties did not provide for production of the information, we used the date the parties entered the stipulation.

¹⁵⁰ See *infra* tbl. 3, Panels A, B.

¹⁵¹ See *infra* tbl. 3, Panel C.

¹⁵² See *infra* tbl. 3.

¹⁵³ While there are many expenses involved in resolving legal disputes, we think it

with practicing Delaware attorneys, who confirmed that our method would provide a crude idea of legal costs. These attorneys also estimated that the cost of bringing an uncomplicated stocklist case to trial would fall between \$10,000 and \$25,000. However, they noted that this estimated range could increase if the company chooses to strongly resist the plaintiff's request.

To examine litigation costs more closely, we looked at three subsets of pages filed: PLTPAGES, the number of pages filed by the plaintiff; DEFPAGES, the number of pages filed by the defendant; and TOTPAGES, the total number of pages filed by both parties.¹⁵⁴ The mean number for all three variables is slightly higher for shareholders who did not obtain a stocklist than for those who did, while the median is lower for all three variables.¹⁵⁵

Next, we examine the likely effect of cost on a potential plaintiff's success in obtaining a stocklist by looking at the relationship of the plaintiffs' filings and defendants' responses. Intuition suggests that these two variables will be highly correlated; that is, if a plaintiff files a large amount of litigation papers, the defendant will respond in kind. In fact, the Pearson correlation coefficient between PLTPAGES and DEFPAGES is .73 (p-value < 0.001), which confirms that this intuition is accurate.

We also looked at the ratio of the total number of pages filed by the plaintiff to the total number of pages filed by both parties in order to measure the probable relative burdens on the parties of litigating inspection cases (PLTTOTAL).¹⁵⁶ Our hypothesis was that a plaintiff would file a higher proportion of pages in cases where the plaintiff obtains a stocklist. Both univariate tests, however, fail to show a statistically significant difference.¹⁵⁷

C. *The Books and Records Cases*

Tables 4 through 6 compile the data on our books and records sample in the same manner as for the stocklist cases.¹⁵⁸ Table 4 shows that share-

is reasonable to conclude that total litigation costs increase with increases in court filings. An alternative measure of filings would be the number of documents filed by the parties. As one commentator pointed out to us, the computerization of legal practice may mean that lawyers can complete and file form documents with large numbers of pages just as easily as short ones. We decided to stay with the number of pages filed because the Delaware lawyers we interviewed told us that either measure would be equally likely to capture the cost effect we are seeking to measure.

¹⁵⁴ As with the DELAY variable, we believe that the median levels of the variables are likely to be more informative because of the presence of large outliers.

¹⁵⁵ See *infra* tbl. 3.

¹⁵⁶ See *infra* tbl. 3, Panels A, B.

¹⁵⁷ See *infra* tbl. 3, Panel C.

¹⁵⁸ See *supra* Part III.B.

holders did not obtain books and records in 32% of the cases.¹⁵⁹ As with the stocklist data, most of these cases resulted from voluntary settlements and dismissals of the litigation.¹⁶⁰ As with the stocklist cases, we were unable to obtain conclusive information from the attorneys of record about the result in some of these cases.¹⁶¹ These are listed in the “Dismissal Without Further Information” column and are treated in the same manner as the stocklist data.

The litigated books and records cases where a court issued an opinion are less numerous in our sample than the stocklist cases. The Chancery Court denied the plaintiffs’ requests in 3 of the 16 cases litigated to a decision.¹⁶² The reason for these denials was failure to allege a proper purpose. This indicates that the Delaware courts are turning down some shareholder requests for books and records.

To explore this result further, we examined the shareholders’ stated reasons for seeking to obtain books and records. In Table 5, we show the distribution of shareholders’ stated purposes for demanding books and records, sorted by case outcome.¹⁶³ Because we are particularly concerned with shareholder claims of securities fraud, we focused on cases involving allegations of corporate mismanagement or breach of fiduciary duties by officers and directors, purposes 4 and 6, respectively.¹⁶⁴ Shareholders seeking to uncover potential corporate wrongdoing would be most likely to state one of these purposes. We find that shareholders stated one of these purposes in twenty-six of the fifty-three books and records cases in our sample.¹⁶⁵ The success rate in cases where the share-

¹⁵⁹ See *infra* tbl. 4. This number is a calculation of the total number of times “Plaintiff Does Not Obtain B & R” as a percentage of the total number of cases.

¹⁶⁰ As in the stocklist cases, a plaintiff can obtain the requested books and records either through a court order or through an agreement of the parties dismissing the lawsuit. In all sixteen cases where a court order was entered, the order either denied the shareholder’s request (a failure) or ordered the defendant to produce the books and records (a success). See *infra* tbl. 4. In the remaining thirty-seven cases, the plaintiff dismissed, or the parties agreed to dismiss, the lawsuit and filed a stipulation of dismissal. See *infra* tbl. 4. This stipulation commonly states the conditions of the dismissal, which may or may not include the production of books and records. When the stipulation stated that the defendant would provide to the plaintiff the books and records, we counted that as a success. If the stipulation did not provide for production of the books and records, we counted that as a failure. As noted in the text, we contacted the attorneys in these cases to determine if our classification of dismissals without books and records as failures was correct.

¹⁶¹ See *supra* note 134 and accompanying text.

¹⁶² See *infra* tbl. 4.

¹⁶³ See *infra* tbl. 5.

¹⁶⁴ See *infra* tbl. 5.

¹⁶⁵ See *infra* tbl. 5. The numbers presented in Table 5 do not directly correspond to these figures because shareholders sometimes stated multiple purposes. We have

holders stated one of these two purposes is approximately 64%.¹⁶⁶ This is nearly identical to the 63% rate for shareholders alleging other purposes.¹⁶⁷ We note that the frequency distribution of stated purposes for books and records cases shown in Table 5 is much more dispersed than in the stocklist cases.

All of the other books and records variables are defined in the same manner as the stocklist data.¹⁶⁸ We present descriptive statistics for these variables in Table 6.¹⁶⁹ Panel A presents summary statistics for those cases where the plaintiff obtained books and records, while Panel B provides the same statistics for those cases where the plaintiff did not get the books and records.¹⁷⁰ Panel C shows t-statistics for differences in the variable means and Wilcoxon Z-statistics for differences in the variable medians.¹⁷¹

The DELAY variable shows that the median and mean delays for successful shareholders are about three months and over seven months, respectively, while the median and mean delays for unsuccessful shareholders are about nine months and over eleven months, respectively.¹⁷² The differences between these medians are significant at the 5% confidence level and the differences between the means are significant at the 10% confidence level.¹⁷³

Once again, we use the number of pages of litigation filings as a proxy for the cost of a books and records lawsuit, with the intuition that the more pages a party files, the greater its legal expenses will be. As before, we confirmed this by interviewing Delaware attorneys. These attorneys also estimated the cost of a books and records case at \$25,000 to \$50,000. Once again, they noted that this fee range would rise if the company strongly resisted the shareholders' demand.

Using the same variables as used in the stocklist cases—PLTPAGES, DEFPPAGES, and TOTPPAGES—we find in books and records cases that unsuccessful shareholders have insignificantly lower mean and median numbers of pages filed for PLTPAGES and TOTPPAGES, although the

separately calculated the statistics in the text accompanying this note and notes 166 and 167 *infra*.

¹⁶⁶ See *infra* tbl. 5. This number is a calculation of the total number of times "Plaintiff Obtains B & R" by using purposes 4 and 6 as a percentage of the total number of times purposes 4 and 6 were used.

¹⁶⁷ See *infra* tbl. 5. This number is a calculation of the total number of times "Plaintiff Obtains B & R" by using purposes 1, 2, 3, 5, and 7 as a percentage of the total number of times purposes 1, 2, 3, 5, and 7 were used.

¹⁶⁸ See *supra* Part III.B.

¹⁶⁹ See *infra* tbl. 6.

¹⁷⁰ See *infra* tbl. 6, Panels A, B.

¹⁷¹ See *infra* tbl. 6.

¹⁷² See *infra* tbl. 6, Panels A, B.

¹⁷³ See *infra* tbl. 6, Panel C.

reverse is true for DEFPAGES.¹⁷⁴ We also find that the Pearson correlation coefficient between PLTPAGES and DEFPAGES is .69 (p-value < 0.001), evidencing a high correlation between filings of plaintiffs and defendants in these cases.

IV. ANALYSIS OF RESULTS

A. Caveats

Before considering the policy implications of our results for legal reform, we should highlight several qualifications that counsel caution in interpreting these results. First, based on our sample of litigated cases, we were unable to measure the number of successful shareholders who received documents under the Delaware inspection statute without recourse to litigation. As a result, our statistics may overstate the costs to shareholders of using the inspection procedure to obtain information.¹⁷⁵

Second, we cannot determine every reason why cases may have settled without the shareholder obtaining the stocklist or books and records. In some of these cases, it is possible that the shareholder filed suit to pressure the company to provide other relief, obtained the information without mentioning it in the stipulation filed with the court, or decided for reasons unrelated to the litigation that it no longer needed the stocklist or books and records. Classifying these cases as failures may overstate the number of unsuccessful cases. We have partially corrected for this problem by gathering additional information from lawyers that litigated these cases.¹⁷⁶ However, as noted above, there are still numerous cases with uncertain results.

Third, we cannot measure plaintiff's success in obtaining all of the books and records needed to properly investigate suspected mismanagement or fraud. The courts restrict successful plaintiffs to those documents that are "essential and sufficient" to achieve the plaintiff's stated purpose.¹⁷⁷ These documents may not be enough for the plaintiffs to determine if their suspicions of fraud are well founded.

¹⁷⁴ See *infra* tbl. 6, Panels A, B. In other words, we are unable to substantiate our hypotheses (discussed in note 153 and the accompanying text) that there are statistically significant differences between the number of pages filed by successful and unsuccessful plaintiffs and between successful and unsuccessful defendants.

¹⁷⁵ We searched Securities and Exchange Commission (SEC) filings for all public corporations to locate available data on companies reporting stocklist demands, but the data we generated were clearly incomplete. Federal law does not require reporting companies to disclose this information. See 15 U.S.C. § 78m(a) (1994) (stating that an issuer of securities must make a report to the SEC containing information as prescribed by the SEC); 17 C.F.R. §§ 240.13a-1 to 240.13f-2 (1996) (listing the information an issuer of securities must disclose in its reports).

¹⁷⁶ See *supra* notes 134-35 and accompanying text.

¹⁷⁷ See *FOLK, supra* note 13, at § 220.5 n.68 (compiling cases involving limitations on the records that will be provided under the Delaware inspection statute).

With all of these qualifications in mind, we turn to our analysis of the data.

B. *Is The Delaware Inspection Statute An Effective Discovery Device For Potential Securities Fraud Plaintiffs?*

What does our empirical research tell us about the usefulness of the Delaware inspection statute as a pre-litigation discovery device for plaintiffs contemplating securities fraud actions? Our results suggest several reasons why plaintiffs' lawyers have not rushed to use the Delaware inspection statute as a pre-suit discovery device.

First, filing a books and records action led to obtaining at least some of the desired information in only about two-thirds of the cases in our sample.¹⁷⁸ Even where the plaintiffs' purpose was to investigate corporate mismanagement or fraud, as it would be if plaintiffs chose to follow the *Rales* court's suggestion,¹⁷⁹ shareholders whose stated purpose was to investigate corporate wrongdoing did no better than those with other purposes; both groups failed to obtain books and records in about one-third of the cases.¹⁸⁰ Shareholders using the Delaware inspection statute to obtain a stocklist were successful in about 78% of the cases examined,¹⁸¹ but this information is only useful if a plaintiff decides that it has a sufficient basis to file a securities fraud complaint.¹⁸²

Second, plaintiffs likely will face substantial delays in pursuing an inspection suit. The median successful stocklist plaintiff in our sample spent over a month in litigation, while unsuccessful plaintiffs waited even longer.¹⁸³ The successful books and records plaintiff's median wait exceeded three months, while the median unsuccessful shareholder spent over eight months in litigation.¹⁸⁴

Third, plaintiffs likely will face substantial costs, at least \$10,000 to \$25,000, in litigating a stocklist case, and \$25,000 to \$50,000 in pursuing a books and records case, before even determining if they should file a securities fraud action.¹⁸⁵ However, these costs will be at least partially off-

¹⁷⁸ See *infra* tbl. 4. The books and records were obtained in 68% of the cases. This number is a calculation of the total number of times "Plaintiff Obtains B & R" as a percentage of the total number of cases in the sample.

¹⁷⁹ See *supra* notes 74-76 and accompanying text.

¹⁸⁰ See *supra* notes 166-67 and accompanying text.

¹⁸¹ See *infra* tbl. 1. This number is a calculation of the total number of times "Plaintiff Obtains List" as a percentage of the total numbers of cases in the sample.

¹⁸² As noted above, a stocklist will be useful to a potential securities plaintiff largely as a means of contacting other prospective plaintiffs to join the action. See *supra* text accompanying notes 12, 103-12.

¹⁸³ See *infra* tbl. 3.

¹⁸⁴ See *infra* tbl. 6.

¹⁸⁵ However, if the shareholder decides to file a securities fraud action based on evidence it uncovered in the inspection case, it will not need to engage in as much (or

set by reductions in the discovery costs in the subsequent securities fraud action. In fact, there may be some net cost reductions if it is faster and less costly to obtain information about potential securities fraud through an inspection proceeding—which is an expedited and summary proceeding—than through the normal discovery process in a securities fraud action.¹⁸⁶ Discovery under the inspection statute also could be more focused than in a securities fraud case.¹⁸⁷

any) discovery in the fraud case. This will reduce costs in the second action. In fact, if the expedited summary inspection proceeding is a cheaper method of obtaining discovery than regular civil litigation, it may be more efficient for the plaintiff to use it.

The relative efficiency of seeking books and records under the inspection statute versus using the regular discovery process in class action litigation under FRCP 26 can only be ascertained by further empirical research. The mandatory discovery procedures under FRCP 26(a) do provide plaintiffs with some information relatively quickly. Our discussions with practicing attorneys in Delaware about the comparative advantages of the two systems lead us to believe for several reasons that the inspection statute procedure is preferable for plaintiffs in most cases.

First, and most obviously, the Reform Act renders the usual discovery procedure unavailable to plaintiffs in securities fraud cases. *See supra* Part I.B. Even if Congress altered the Reform Act to make such discovery possible, the Delaware lawyers we spoke with expressed a strong preference for the inspection procedure. They believe that the information they receive through this procedure is more complete because it is not redacted and is produced subject to closer judicial scrutiny, thereby reducing the number of discovery disputes. For further discussion of this point, see Cathy L. Reese & Randall S. Thomas, *The Shareholder As Inspector: Using State Statutory Rights to Monitor Management* (1997) (working paper on file with authors).

¹⁸⁶ *Cf. supra* notes 183-84. To make this comparison, one would need to collect information on the time and cost of discovery in securities fraud actions. The authors have not collected this data and are unaware of any existing data on the issue.

¹⁸⁷ If this is the case—and we have no data to prove that it is—the narrow focus of discovery will have positive and negative aspects for the plaintiff. The benefit to plaintiffs is that they may need to expend fewer resources to get documentary information about the alleged fraud sufficient to determine whether they should file suit. Even circumstantial evidence of fraud that would satisfy the intent requirement would be sufficient to survive a motion to dismiss. The negative aspect of this highly focused discovery is that the plaintiff only has access to written materials, not oral testimony. While the documentary record may be enough to determine whether fraud has occurred—or at least to find enough evidence of fraud to satisfy the Reform Act's pleading requirements—it is possible that such evidence only would be available through oral testimony. While we cannot quantify the number of cases where this may be the case, it should be borne in mind that the plaintiff only needs to find enough evidence to satisfy the fraud pleading requirements. If the written record does not yield even this amount of evidence of fraud, this would suggest either that no fraud has occurred or that the defendant has hidden or destroyed its records of the fraud. The latter scenario is troubling in all litigation, and if evidence of such concealment or destruction is found, this could be grounds for asking a court to take extraordinary action, such as ordering oral testimony. *See, e.g.,* Milo Geyelin, *DuPont*

Fourth, plaintiffs with strong reasons to suspect corporate wrongdoing and enough evidence to plead fraud with particularity need not wait the additional time to litigate a books and records case. A shareholder should consider using section 220 only in borderline cases, where the shareholder is uncertain whether it will be able to meet the fraud pleading requirements of the Reform Act. Although plaintiffs who suspect corporate wrongdoing will not want to wait the additional time to find out if they will obtain books and records before filing their securities fraud action, the trial court could permit the plaintiffs to pursue their inspection case and refrain from deciding any motions to dismiss in the securities fraud action until the inspection case has been resolved. However, even plaintiffs whose inspection action is successful will have to spend tens of thousands of dollars and go through a summary trial, just to obtain the documents needed to learn if they have a viable fraud claim.

On the other side of the coin, the potential benefits of examining corporate documents could be particularly significant for plaintiffs considering suing nonregistered companies. In these instances, there may be few public sources of information.¹⁸⁸

In the case of a registered company,¹⁸⁹ a plaintiff can gain access to

Again Faces Allegations of Withholding Benlate Test Data, WALL ST. J., Mar. 27, 1995, at B6 (reporting that a federal judge ordered DuPont to show why it should not be guilty of fraud for allegedly withholding discoverable evidence).

¹⁸⁸ See Thomas, *supra* note 1, at 360 n.157 (describing information available from registered companies).

¹⁸⁹ Our analysis and data focus on the Delaware statute because of Delaware's importance as the state of incorporation of such a large number of publicly held companies. Delaware is also the home of a very large number of private corporations. The statistics that we present may be less useful for litigants seeking information about corporations that are not incorporated in Delaware. Plaintiffs would prefer to seek inspection in states where the corporation laws provide a summary method of judicial review of inspection demands. The Model Business Corporation Act (MBCA) gives shareholders such a right. See 4 MODEL BUS. CORP. ACT ANN. § 16.04(a) (1985 & Supp. 1996). All but seven states follow the MBCA's pattern of "expressly providing for a statutory inspection proceeding under which a court of competent jurisdiction may compel the production of corporate records for examination by a qualified shareholder." *Id.* at 16-65 to 16-66 (as of December 1, 1995). Some of these state statutes track the language of the MBCA provision, providing this proceeding as a summary one. See, e.g., ARIZ. REV. STAT. ANN. § 10-1604 (West 1996); COLO. REV. STAT. § 7-116-104 (Supp. 1996); FLA. STAT. ANN. ch. 607.1604 (West 1993). Other state statutes have similar expedited inspection mechanisms, albeit in slightly different form. See CAL. CORP. CODE § 1603 (West 1990) (providing for judicial enforcement of inspection demands with "just and proper conditions"); N.Y. BUS. CORP. LAW § 624 (McKinney 1986) (providing for summary process in inspection statute). Some judges may be unfamiliar with inspection cases because such cases are litigated infrequently outside Delaware. This may result in longer delays, greater variation in outcomes, and possibly greater costs. We would strongly argue for changes to the existing statutes and procedures in states where plaintiffs face these obstacles.

internal company documents if it wins a books and records case. These documents could give the plaintiff grounds to plead with particularity a securities fraud action. Moreover, if the plaintiff examines these documents and finds no evidence of fraud, it can save itself the expense of continued litigation by dismissing (or not filing) the securities case.

Shareholders who engage in this form of discovery would have a strong argument that they should have a lead role in the securities litigation. Their actions would illustrate their determination and adequacy as a class representative. Although a larger shareholder could claim that it should occupy this lead position by virtue of the Reform Act's presumption that the largest shareholder is the most adequate lead plaintiff, that presumption is rebuttable.¹⁹⁰ Shareholders that have already successfully litigated a books and records case and discovered evidence of fraud should have a convincing argument that they are entitled to be lead plaintiff.

CONCLUSION

We conclude that many shareholders will be reluctant to rely on the Delaware inspection statute as a method of pre-securities fraud litigation discovery. Inspection actions are lengthy and costly, and they have uncertain outcomes. If Delaware wants to provide shareholders with a better avenue of pre-suit discovery through its inspection statute, it should consider streamlining the existing process. It could do this by amending its inspection statute to provide for quicker trials, attorney fee awards against defendants that unjustifiably resist shareholder's legitimate inspection demands, and other mechanisms to give potential securities plaintiffs more liberal access to corporate documents.¹⁹¹

¹⁹⁰ See *supra* note 47 and accompanying text.

¹⁹¹ For further discussion of possible reforms to the Delaware inspection statute, see Thomas, *supra* note 1, at 364-69.

TABLE 1
 SAMPLE OF FILINGS IN DELWARE CHANCERY COURT TO
 OBTAIN STOCKHOLDER LIST

Year of Filing	<i>Plaintiff Obtains List</i>			<i>Plaintiff Does Not Obtain List</i>		
	Number of Filings Per Year	Decision in Favor of Plaintiff	Dismissal With List	Decision Against Plaintiff	Dismissal Without List	Dismissal Without Further Information
1981	1	0	1	0	0	0
1982	6	1	1	0	0	4
1983	4	4	0	0	0	0
1984	15	5	7	1	0	2
1985	8	1	4	1	0	2
1986	7	4	3	0	0	0
1987	5	0	5	0	0	0
1988	5	0	3	1	0	1
1989	5	0	3	1	0	1
1990	7	1	6	0	0	0
1991	5	0	3	0	0	0
1992	12	6	5	0	1	0
1993	10	3	4	0	3	0
1994	1	0	1	0	0	0
Total	91	25	46	4	4	12

TABLE 2
 FREQUENCY DISTRIBUTION OF STATED PURPOSES FOR USE
 OF STOCKHOLDER LIST

	<i>Plaintiff Obtains List</i>		<i>Plaintiff Does Not Obtain List</i>		
	Decision in Favor of Plaintiff	Dismissal With List	Decision Against Plaintiff	Dismissal Without List	Dismissal Without Further Information
1. To value the firm's stock	4	8	0	2	4
2. To contact shareholders about soliciting proxies or written consents	13	23	2	1	3
3. To contact shareholders about a tender offer	5	10	0	1	3
4. To investigate whether management is breaching its fiduciary duty to shareholders through mismanagement, negligence, waste, fraud, self-dealing, etc.	2	9	1	2	0
5. To communicate with other shareholders regarding proposals by management or proposals to be voted on the annual meeting	3	4	1	0	1
6. To fulfill fiduciary duty as a member of the Board of Directors	1	1	0	0	1
7. Miscellaneous	2	3	0	2	1
8. Not stated	0	1	0	0	0
Total ^a	30	59	4	8	13

^a Total exceeds total number of filings from table 1 (91) due to multiple purposes given.

TABLE 3
 DESCRIPTIVE STATISTICS OF VARIABLES ASSOCIATED WITH
 REQUEST FOR STOCKHOLDER LIST BY OUTCOME
*(Dismissals Without Further Information
 are considered unsuccessful)*

Variable ^a	Mean	Standard Deviation	Minimum	Median	Maximum
<i>Panel A: Plaintiff Obtains Stockholder List (N=71)</i>					
DELAY	111.9	168.4	9	43	980
PLTPAGES	81.1	111.9	4	39	700
DEFPAGES	56.7	91.2	0	18	500
TOTPAGES	137.8	187.9	8	66	1,200
PLTPAGES	68.4%	22.6%	6.0%	71.4%	100.0%
<i>Panel B: Plaintiff Does Not Obtain Stockholder List (N=20)</i>					
DELAY	187.2	256.5	9	70	876
PLTPAGES	128.1	344.5	4	19	1,500
DEFPAGES	79.7	177.6	0	5	600
TOTPAGES	207.8	493.9	7	26	2,150
PLTPAGES	70.3%	31.4%	6.3%	74.8%	100.0%
<i>Panel C: t-statistics for Test of Differences in Means and Wilcoxon Z-statistics for Tests for Differences in Medians Between Panels A and B</i>					
Variable ^a	t-statistic		Wilcoxon Z-statistic		
DELAY	1.24		1.02		
PLTPAGES	0.60		2.56***		
DEFPAGES	0.56		1.55		
TOTPAGES	0.62		1.83*		
PLTTOTAL	0.25		0.95		

*** The variables in panels A and B are statistically different at the .01 level.

* The variables in panels A and B are statistically different at the .10 level.

^a Variable definitions are as follows:

DELAY	Number of days between demand and outcome dates.
PLTPAGES	Number of pages filed by plaintiff.
DEFPAGES	Number of pages filed by defendant.
TOTPAGES	Total number of pages filed by plaintiff and defendant.
PLTTOTAL	Percentages of total litigation pages filed by plaintiff.

TABLE 4
 SAMPLE OF FILINGS IN DELAWARE CHANCERY COURT TO
 OBTAIN BOOKS AND RECORDS (B&R)

Year of Filing	<i>Plaintiff Obtains B&R</i>			<i>Plaintiff Does Not Obtain B&R</i>		
	Number of Filings Per Year	Decision in Favor of Plaintiff	Dismissal With B&R	Decision Against Plaintiff	Dismissal Without B&R	Dismissal Without Further Information
1981	1	1	0	0	0	0
1982	1	0	0	0	0	1
1983	1	1	0	0	0	0
1984	3	2	1	0	0	0
1985	2	0	1	0	0	1
1986	3	2	1	0	0	0
1987	4	0	3	0	0	1
1988	5	0	3	1	0	1
1989	7	2	1	0	0	4
1990	6	0	4	1	0	1
1991	5	0	3	0	0	2
1992	6	2	2	1	0	1
1993	8	3	3	0	2	0
1994	1	0	1	0	0	0
Total	53	13	23	3	2	12

TABLE 5
 FREQUENCY DISTRIBUTION OF STATED PURPOSES FOR USE
 OF BOOKS AND RECORDS (B&R)

	<i>Plaintiff Obtains B&R</i>		<i>Plaintiff Does Not Obtain B&R</i>		
	Decision in Favor of Plaintiff	Dismissal With B&R	Decision Against Plaintiff	Dismissal Without B&R	Dismissal Without Further Information
1. To value the firm's stock	6	11	0	2	10
2. To contact shareholders about soliciting proxies or written consents	2	6	2	0	0
3. To contact shareholders about a tender offer	0	2	1	0	0
4. To investigate whether management is breaching its fiduciary duty to shareholders through mismanagement, negligence, waste, fraud, self-dealing, etc.	5	11	1	2	4
5. To communicate with other shareholders regarding proposals by management or proposals to be voted on the annual meeting	0	2	1	0	0
6. To fulfill fiduciary duty as a member of the Board of Directors	2	2	0	0	1
7. Miscellaneous	1	3	0	2	1
Total^a	16	37	5	6	16

^a Total exceeds total number of filings from table 6 (53) due to multiple purposes given.

TABLE 6
 DESCRIPTIVE STATISTICS OF VARIABLES ASSOCIATED WITH
 REQUEST FOR BOOKS AND RECORDS BY
 OUTCOME

(Dismissals Without Further Information are considered unsuccessful)

Variable ^a	Mean	Standard Deviation	Minimum	Median	Maximum
<i>Panel A: Plaintiff Obtains Books and Records (N=36)</i>					
DELAY	210.7	242.4	8	109	980
PLTPAGES	93.3	219.3	6	35	1,342
DEFPAGES	55.6	85.4	0	13	341
TOTPAGES	148.9	277.9	8	61	1,648
PLTPAGES	70.0%	25.3%	20.0%	74.5%	100.0%
<i>Panel B: Plaintiff Does Not Obtain Books and Records (N=17)</i>					
DELAY	347.8	275.6	27	259	876
PLTPAGES	86.8	171.1	4	25	700
DEFPAGES	59.5	119.7	0	19	500
TOTPAGES	146.4	288.7	6	46	1,200
PLTPAGES	67.5%	27.4%	6.3%	72.7%	100.0%

*Panel C: t-statistics for Test of Differences in Means and Wilcoxon Z-statistics for
 Tests for Differences in Medians Between Panels A and B*

Variable ^a	t-statistic	Wilcoxon Z-statistic
DELAY	1.84*	2.00**
PLTPAGES	0.11	1.19
DEFPAGES	0.12	0.07
TOTPAGES	0.03	0.51
PLTTOTAL	0.34	0.29

** The variables in panels A and B are statistically different at the .05 level.

* The variables in panels A and B are statistically different at the .10 level.

^a Variable definitions are as follows:

DELAY	Number of days between demand and outcome dates.
PLTPAGES	Number of pages filed by plaintiff.
DEFPAGES	Number of pages filed by defendant.
TOTPAGES	Total number of pages filed by plaintiff and defendant.
PLTTOTAL	Percentages of total litigation pages filed by plaintiff.

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