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[Delaware Supreme Court Reverses Chancery Court Dismissal Of Derivative Plaintiff's Section 220 Books And Records Action](#)

In [King v. VeriFone Holdings, Inc.](#), No. 330, 2010, 2011 WL 284966 (Del. Jan. 28, 2011), the [Supreme Court of the State of Delaware](#) reversed a decision by the [Court of Chancery](#) dismissing a derivative plaintiff's action under [Section 220 of the Delaware General Corporation Law](#) seeking books and records of a Delaware corporation. The Supreme Court held that the Chancery Court erred as a matter of law when it held that the purpose of plaintiff's demand to inspect books and records – to assist in bolstering demand futility allegations in a parallel shareholder derivative complaint filed in a California federal court – was improper. The Supreme Court explained that although the plaintiff's simultaneous pursuit of a derivative action and a Section 220 books and records action was perhaps ill advised, it was not impermissible under prevailing Delaware law.

As explained previously [see blog article about the Chancery Court's opinion [here](#)], defendant VeriFone Holdings, Inc. (“VeriFone”) provides secured electronic payment technologies such as point-of-sale software and terminals, security and encryption software. On December 3, 2007, VeriFone announced it would restate its financial statements for the first three quarters of fiscal year 2007 due to accounting errors that occurred when Verifone acquired Lipman Electronic Engineering, Ltd. The disclosure led to an investigation and the filing of a civil complaint by the [Securities and Exchange Commission](#), as well as a stock price drop and the filing of, among other actions, a shareholder derivative suit in the [United States District Court for the Northern District of California](#).

Prior to bringing suit, however, plaintiff did not undertake any pre-suit investigation. VeriFone challenged the derivative complaint based on failure to establish that demand on the VeriFone board of directors would have been futile. The district court granted Verifone's motion to dismiss the derivative complaint on the ground that plaintiff could not allege that the independent board majority at Verifone faced the prospect of personal liability for committing accounting fraud. Plaintiff amended his complaint, but that complaint was dismissed on the same ground, again without prejudice.

In an effort to bolster his demand futility allegations and rectify the shortcomings of his twice-dismissed complaint, plaintiff filed an action in Delaware Chancery Court under Section 220 seeking disclosure of internal books and records from VeriFone. Plaintiff's only stated purpose for examining the books and records of VeriFone was to help him plead a viable theory of demand futility for the derivative action in the California federal court.

The Chancery Court dismissed the Section 220 action, applying the Supreme Court's oft-repeated view that derivative plaintiffs should seek books and records and otherwise conduct adequate investigation into demand futility *before* filing a derivative complaint. To allow otherwise, the Chancery Court opined, would result in a waste of judicial resources. Additionally, filing the Section 220 action in Delaware while the related suit was pending in California went against public policy of avoiding subjecting defendants to concurrent suits in different forums. Plaintiff appealed.

The Supreme Court reversed. It held that while its prior precedents have frowned upon the premature filing of derivative

actions and have strongly suggested that putative plaintiffs use the “tools at hand” (e.g., Section 220) to investigate claims before filing suit, those decisions did not establish a bright line rule barring a Section 220 action while a parallel derivative action is pending. The Court cited several cases in which a Section 220 action was either permitted or encouraged to assist a derivative plaintiff in investigating and gathering facts to support demand futility arguments. Here, the Supreme Court noted that the California district court’s dismissal of the derivative complaint was without prejudice; had the dismissal been with prejudice, it appears, the Court likely would have affirmed the dismissal of the Section 220 action. The Supreme Court also noted that the Chancery Court has other, less draconian remedies to address the harm caused to corporate defendants when plaintiffs “race to the courthouse” to file derivative actions that ultimately lack merit.

Although this decision takes some pressure off derivative plaintiffs who lack sufficient facts to plead demand futility, it should be noted that the scope of a demand for books and records under Section 220 is much narrower than the scope of discovery available under the Chancery Rules of Court. As a general rule, such discovery remains prohibited unless and until a derivative plaintiff demonstrates with particularity in the complaint that he or she has standing to pursue the claim due to the futility of demand. This decision by the Supreme Court does not alter that long-standing practice in the Delaware courts.

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