DELAWARE BUSINESS COURT INSIDER

August 2, 2017

An ALM Website

Losing Stockholder Standing to Assert and Enforce Corporate Inspection Rights

By Jacqueline P. Rubin and Matthew D. Stachel

The rights of stockholders to demand to inspect a corporation's books and records under state corporation laws are a powerful method of ensuring the stockholders' rights and interests are safeguarded. Such inspection rights are not, however, unfettered. Exercising them involves balancing the inspection rights with the rights of corporations "to be free of frivolous or vexatious demands to examine records, and to avoid production of records to individuals pursuing interests other than those relating to stock ownership." To strike an appropriate balance, stockholders must first comply with certain requirements. Among these are requirements governing the making of an inspection demand on the corporation and the requirement of articulating a proper purpose for the demanded inspection.

A more fundamental requirement—that can be taken for granted—is that the stockholders must have standing as stockholders, both when the inspection demand is made and when they file a lawsuit seeking to enforce their inspection rights. But stockholder standing can be lost in more ways than the voluntary disposition of the stockholders' shares. Courts have recently considered the impact of some of these situations, including corporate life-cycle events like mergers and other federal and state statutes. Practitioners who represent stockholders and those

Jacqueline P. Rubin and Matthew D. Stachel

who represent corporations should be mindful of these situations when counseling their clients.

Merger Held to Divest Stockholder of Standing

In *Weingarten v. Monster Worldwide*, C.A. No. 12931-VCG, (Del. Ch. Feb. 27). the Delaware Court of Chancery considered (as a matter of first impression) the effect of a merger that deprived a stockholder of his stock on the stockholder's subsequent lawsuit seeking to compel the corporation's compliance with Delaware's books and records statute. In August 2016, Monster Worldwide, Inc. (Monster) entered into a merger agreement that contemplated that all of its outstanding stock would be acquired through a cash tender offer pursuant to 8 Del. C. Section 251(h). The tender offer began on Sept. 6, 2016, and expired at midnight on Oct. 28, 2016. On Nov. 1, following the successful consummation of the tender offer, all of Monster's outstanding stock, excluding shares held by the acquirer, Monster, and stockholders who validly exercised their appraisal rights, was cancelled and converted into the right to receive the merger consideration.

Monster stockholder Joe Weingarten submitted an inspection demand on Oct. 19, 2016, several weeks after the launch of the tender offer. Weingarten sought to inspect certain books and records to determine whether to pursue litigation against some of Monster's directors for alleged wrongdoing in connection with the contemplated transaction. Monster rejected the demand, but expressed a willingness to discuss a narrow production. Weingarten attempted to discuss that production with Monster, but reached no agreement and filed no complaint before the transaction closed. Weingarten's stock was among the shares cancelled following the tender offer. On Nov. 22, 2016, Weingarten filed an action in the Court of Chancery to compel the corporation to grant his demanded inspection.

In its post-trial opinion, the Court of Chancery held that Weingarten lacked stockholder standing because he was not a stockholder when he filed his complaint. The court reasoned that by requiring a plaintiff to demonstrate "both that it 'has'—past tense—complied with the demand requirement, and that it 'is'—present tense—a stockholder, the legislature has made clear that only those who are stockholders at the time of filing have standing to invoke this court's assistance."

The court also distinguished two previous Court of Chancery opinions: *Cutlip v. CBA International*, C.A. No. 14168 NC, (Del. Ch. Oct. 27, 1995), and *Deephaven Risk Arb Trading v. UnitedGlobalCom*, C.A. No. 379-N, Del. Ch. July 13, 2005). Both of those cases involved stockholders who lost their stock due to mergers while their books and records actions were pending. In both of those cases, the court held that the subsequent loss of stock did not deprive the stockholders of standing because they had standing at the time they filed suit.

Following *Weingarten*, practitioners should consider the effect of corporate life-cycle events like mergers on pending books and records demands. For example, practitioners representing stockholders should be prepared to file a books and records lawsuit before the merger or tender offer closes to maintain standing to enforce their inspection rights.

Federal Statute Held to Divest Stockholder of Standing

In *Pagliara v. Federal Home Loan Mortgage*, the U.S. District Court for the Eastern District of Virginia examined whether a federal statutory transfer of power to a conservator deprived a junior preferred stockholder of his standing to demand inspection of the Federal Home Loan Mortgage Corporation (Freddie Mac). Freddie Mac is a federally chartered corporation, but its organizational documents obligated it to follow the corporate governance practices and procedures of the commonwealth of Virginia, including Virginia's books and records statute. The court held that the stockholder lacked standing.

During the Great Recession, Congress passed the Housing and Economic Recovery Act of 2008 (HERA), which created the Federal Housing Finance Authority (FHFA) to regulate Freddie Mac. HERA authorized FHFA to place Freddie Mac in conservatorship and also provided that if FHFA becomes Freddie Mac's conservator, then FHFA shall "immediately succeed" to "all rights, titles, powers and privileges" of any Freddie Mac stockholder with respect to Freddie Mac and its assets.

In September 2008, exercising this authority under HERA, FHFA became Freddie Mac's conservator. The next day, FHFA caused Freddie Mac to enter into a senior preferred stock purchase agreement with the United States Department of the Treasury. In 2013, an amendment to that agreement gave the Treasury Department the right to a receive a quarterly dividend from Freddie Mac in the amount of Freddie Mac's net worth, except for a small capital reserve. After the amendment, Freddie Mac paid to the Treasury Department approximately $74 billion in dividends but paid no dividends to its junior preferred stockholders.

In January 2016, Timothy Pagliara, a junior preferred stockholder of Freddie Mac, submitted a books and records demand to Freddie Mac. Pagliara sought to inspect certain documents to determine whether to institute a lawsuit against Freddie Mac's directors and others in relation to the 2013 amendment and the declaring of dividends pursuant to that amendment. Freddie Mac did not respond to the demand, but FHFA did, explaining that Freddie Mac's directors served on FHFA's behalf and thus owed no fiduciary duties to its other stockholders. Pagliara filed a lawsuit six weeks later, seeking to compel Freddie Mac to grant his inspection demand.

In its memorandum opinion, the Eastern District of Virginia held that *Pagliara* lacked standing to assert inspection rights. The court reasoned that Virginia's books and records statute requires stockholders to have stockholder standing when they submit an inspection demand to the corporation. The court explained that Pagliara lacked stockholder standing because HERA's statutory transfer to FHFA of "all rights, titles, powers, and privileges" of any Freddie Mac stockholder unambiguously included inspection rights.

Pagliara thus reminds practitioners to consider whether there are any federal or state statutes that might affect stockholder standing to assert and enforce inspection rights.

Stock Transfer Restrictions Did Not Divest Stockholder of Standing

In *Henry v. Phixios Holdings*, C.A. No. 12504-VCMR, (Del. Ch. July 10), the Delaware Court of Chancery explored whether written stock transfer restrictions contained in a stockholder agreement were validly applied to revoke a stockholder's stock and thus deprive him of standing to enforce compliance with his books and records demand. When Phixios Holdings, Inc. (Phixios) was formed in July 2013, its board of directors approved and executed a stockholder agreement that contained certain written stock transfer restrictions. Those restrictions provided that stock was subject to revocation by a majority vote of all voting stockholders if a stockholder were "found to be engaging in acts ... that are damaging to Phixios," including working for competitors, willfully disclosing proprietary information, or "other willful acts" harmful to Phixios "as determined by a majority vote of the board of directors and all voting stockholders."

In March 2015, Jon Henry became a Phixios consultant. As part of his compensation, Henry received 50,000 certificated shares of Phixios stock. The stock certificate Henry received did not contain or otherwise note the existence of any stock transfer restrictions. There was no written documentation that Henry was informed of the restrictions, nor did he receive a copy of the stockholder agreement before becoming a stockholder. While a Phixios representative contended that she discussed every provision of the stockholder agreement with Henry before he became a stockholder, according to Henry, the only discussions he had with Phixios concerned the company's delay in issuing the shares to him.

In May 2016, Henry's consulting relationship with Phixios was terminated. In early June 2016, Phixios sent Henry a cease and desist letter, asserting that he had worked for a competitor while he was a Phixios consultant.

On June 23, 2016, Henry submitted a books and records demand to Phixios, seeking to investigate, among other things, alleged corporate mismanagement. Phixios did not respond to the demand. On July 12, 2016, Phixios held a special meeting of the stockholders at which all of Henry's stock was purportedly revoked pursuant to the stock transfer restrictions contained in the stockholder agreement for allegedly engaging in work for a Phixios competitor. On July 22, 2016, Henry filed a books-and-records lawsuit.

In a post-trial opinion, the Court of Chancery held that the written stock transfer restrictions did not apply to Henry, Phixios's attempt to revoke his stock was invalid, and Henry maintained his status as a stockholder at all relevant times. The court explained that under Section 202 of the Delaware General Corporation Law, a written stock transfer restriction in a stockholder agreement is binding on those who acquire stock if the restriction is noted conspicuously on the stock certificate, the stockholder has actual knowledge of the restriction at the time he acquires the stock, or the stockholder subsequently consents to be bound by the restriction through a stockholder vote or agreement with the stockholders or the corporation. The parties did not dispute that the Phixios stock transfer restrictions were not noted conspicuously on Henry's stock certificate. The court found that Henry did not have actual knowledge of the restriction when he became a stockholder in March 2015, concluding that Henry's testimony that the only discussions he had related to Phixios's delay in issuing him shares was more credible than the testimony of Phixios' representative that she discussed every provision of the stockholder agreement in telephone calls with him. The court also found that Henry did not subsequently assent to the restrictions.

Although the stock transfer restrictions in *Henry* were held unenforceable, the opinion demonstrates that such restrictions could be found valid in a different factual scenario. Like *Pagliara*, *Henry* is a reminder of the effects that different statutory schemes can have on standing to assert and enforce inspection rights.

Conclusion

Weingarten, *Pagliara*, and *Henry* illustrate some of the various ways that stockholders who have not directly transferred their stock could nonetheless lose standing to assert and enforce their inspection rights. Practitioners counseling stockholders and corporations should ensure that they look beyond nominal stock ownership to see if there are other corporate life-cycle events, statutes, or even agreements that might operate to divest stockholders of their inspection rights.

Jacqueline P. Rubin is a partner and **Matthew D. Stachel** is an associate in the litigation department at Paul, Weiss, Rifkind, Wharton & Garrison.