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Weighing options when a company rejects a books, records request

This two-part column addresses some of the relevant considerations when dealing with an Illinois corporation in Illinois courts (part one) and the different considerations at play when the company is a Delaware corporation (part two).

This new monthly column will address the wide range of business, legal and psychological issues that often arise in disputes regarding the ownership and management of business enterprises. The umbrella term most commonly used to describe the practice of lawyers who represent parties in complex ownership disputes is "business divorce."

Whether the parties involved in a business divorce are the owners of a small family business or two public companies in a joint venture, complex ownership disputes often involve a number of recurring themes. The non-controlling party or parties will usually have more limited access to business and financial information about the company and the subject matter of the dispute. Accordingly, the first salvo in a business divorce is often to make a demand on the company for information and documents, also known as a "books and records request," to investigate suspected wrongdoing.

Section 7.75 of the Illinois Business Corporation Act grants every shareholder the right to examine "the corporation's books and records of account, minutes, voting trust agreements … and a record of shareholders, and to make extracts therefrom, but only for a proper purpose." This right is exercised by making "a written demand upon the corporation, stating with particularity the records sought to be examined and the purpose therefor." Section 220 of the Delaware General Corporation Law is similar with respect to both the inspection rights of shareholders and the requirements of a written demand and a proper purpose.

Now suppose that in response to an inspection demand, the company refuses to make available the requested books and records. Should you enforce the shareholder's statutory inspection rights or, instead, just file a lawsuit based on the suspected wrongdoing — with the expectation of issuing discovery requests and receiving the same documents that were the subject of the written inspection demand? That decision may turn on not only the facts of the case, but also on whether the company is an Illinois or Delaware corporation.

This column addresses some of the relevant considerations when dealing with an Illinois corporation in Illinois courts. In part two, we will discuss the different considerations at play when the company is a Delaware corporation.

BUSINESS
DIVORCE

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Rights to information: inspection vs. discovery

On one hand, a mandamus action to compel inspection seems to be the most logical next step after a corporation denies a demand for an examination of books and record. Section 7.75 provides that an officer, agent or a corporation that refuses to allow the examination "shall be [personally] liable … in a penalty of up to ten percent of the value of the shares owned" by the plaintiff. On the other hand, the corporation may challenge the claimed proper purpose either directly (by arguing that the plaintiff's asserted purpose is not a "proper purpose") or indirectly (by arguing that the plaintiff's asserted proper purpose is not their "true purpose").

Improper purposes for a demand include harassment, assisting a competitor and satisfying idle curiosity. But regardless of whether the defense is ultimately successful, disputes over "proper purpose" can be subject to extensive motion practice, written discovery, depositions and even appeals — all before ever reaching a fact hearing (trial) on the issue of proper purpose, which may include the sticky issue of the shareholder's intent. In Illinois, this can cause what is designed to be an expedited procedure to instead drag on for years.

An alternative approach in some circumstances will be to file the substantive complaint (breach of fiduciary duty, for example), including relevant allegations of wrongdoing based on the facts then available (in a direct or derivative claim, as appropriate) and use written discovery requests to get all of the books and records included in the original inspection demand, relying on the more demanding obligation to produce documents in civil discovery (relevant evidence or likely to lead to relevant evidence) and without having to allege or prove a "proper purpose."

The risk with this strategy is that without the examination or records originally requested, you may not be able to plead sufficient facts for the complaint to survive a motion to dismiss. However, in a close case, a court may be more sympathetic to the plaintiff when the company has frustrated the plaintiff's pre-suit efforts to inspect relevant books and records.

Part two will appear next month.

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