

Client Alert

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Flimsy Allegations of Corporate Misconduct Fail to Support a Books and Records Inspection

In *Louisiana Municipal Police Employees' Retirement System v. Lennar Corp.*, C.A. No. 7314-VCG (Del. Ch. Oct. 5, 2012), the Delaware Court of Chancery denied a stockholder's request to inspect a corporation's books and records. The stockholder was purporting to investigate alleged non-compliance with the Fair Labor Standards Act ("FLSA"). As evidence of the alleged wrongdoing, the stockholder cited two articles in the *Wall Street Journal* reporting that the federal government was investigating labor practices at several large home-building companies, including Lennar Corporation. The stockholder also pointed to eight lawsuits filed against Lennar Corporation between 2007 and 2009 that alleged FLSA violations, all of which were settled without any admission of liability.

In order to inspect a corporation's books and records to investigate potential wrongdoing, Delaware law requires that a stockholder allege a "credible basis" from which the court can infer possible mismanagement. The credible basis requirement is a "low standard" with the "lowest possible burden of proof." Nevertheless, the *Lennar* court held that mere press reports of an investigation and the existence of several former lawsuits failed to suggest any misconduct was occurring.

The court found that the prior lawsuits had "low probative value for showing any current wrongdoing." It noted that the lawsuits were settled without any admission of wrongdoing by the corporation. The stockholder also failed to show that the lawsuits were disproportionate or unusual in the home-building industry. Moreover, the lawsuits did not suggest there was any *present* misconduct at the corporation. With respect to the press reports, the court found that two press reports announcing a government investigation do not imply that any of the corporations being investigated actually engaged in any wrongdoing. The court reasoned that the reports simply "describe actions by regulators, not wrongdoing by companies." The court contrasted a prior decision where press reports of backdated and spring-loaded options were corroborated by the plaintiff-stockholder's own statistical analysis, thus entitling the plaintiff to inspect the corporation's books and records.

Numerous Delaware decisions have admonished plaintiffs for not using the so-called "tools at hand" to inspect a corporation's books and records under Section 220 of the Delaware General Corporation Law before filing suit. The inspection can be used to bolster the substantive allegations of the stockholder's complaint or the stockholder's argument that making demand would be futile. Thus, as noted in our recent client alert on [South v. Baker](#), books and records inspections typically are precursors to derivative litigation and should be taken seriously.

At the same time, *Lennar* shows that corporations can successfully resist inspections that lack merit or serve as "fishing expeditions." This is particularly significant with respect to "piggyback" derivative litigation, where stockholders bring breach of oversight (or "*Caremark*") claims against directors based on other litigation brought against the corporation. Delaware law still requires stockholders to have a "proper purpose." Moreover, in the context of investigating potential misconduct, the "credible basis" standard is a low one, but it requires more than "mere suspicion."

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