IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

ROBERT P. BACA,	)	
	)	
Plaintiff,	)	
	)	
v.	)	C.A. No. 5105-VCL
	)	
INSIGHT ENTERPRISES, INC., a Delaware corporation,	)	
	)	
	)	
Defendant.	)	

MEMORANDUM OPINION

Date Submitted: March 31, 2010
Date Decided: June 3, 2010

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LASTER, Vice Chancellor.

Defendant Insight Enterprises, Inc. ("Insight") moves to dismiss this action on the ground that plaintiff Robert P. Baca lacks a proper purpose for seeking to inspect its books and records. Applying *King v. Verifone Holdings, Inc.*, ___ A.2d ___, 2010 WL 1904972 (Del. Ch. May 12, 2010), I dismiss this action with prejudice.

I. FACTUAL BACKGROUND

I draw the facts from Baca's complaint and the documents it incorporates by reference, giving Baca the benefit of all reasonable inferences. I take judicial notice of (i) filings in a pending derivative action that Baca commenced *before* seeking books and records, (ii) filings in a related federal securities action that provided the impetus for Baca's derivative action, and (iii) Insight's filings with the Securities and Exchange Commission ("SEC").

A. Insight Restates Its Financials.

Insight is a Delaware corporation that sells technology hardware, software, and services. On February 9, 2009, Insight announced that it would restate earnings for periods dating back to 2004 to correct how it accounted for aged trade credits. On March 20, 2009, Insight announced that it had received notice of an informal SEC inquiry.

Beginning on March 24, 2009, stockholder plaintiffs filed three putative class action lawsuits in the United States District Court for the District of Arizona (the "Federal Court"). The complaints named Insight and certain of its directors and officers as defendants, alleged violations of the federal securities laws, and sought damages on behalf of purchasers of Insight securities during the period from April 22, 2004 to

February 6, 2009. Two of the lawsuits were voluntarily dismissed; a third remains pending (the "Federal Securities Action").

On May 11, 2009, Insight restated its financials for fiscal years 2006 and 2007 and disclosed that errors had been identified in the company's accounting practices dating back to 1996. The cumulative restatement charge related to aged trade credits was $61.2 million.

B. Baca Files The Federal Derivative Action.

On June 15, 2009, Baca filed a derivative action in the Federal Court (the "Federal Derivative Action"). Although styled as a derivative complaint, Baca's pleading sounded like one of the disclosure complaints from the Federal Securities Action. Paragraph 2 of the derivative complaint illustrates Baca's singular focus on disclosure issues:

> Beginning at least as early as April 2004, and continuing through February 9, 2009 (the "relevant period"), the Individual Defendants, in breach of their fiduciary duties, devised, approved and implemented a plan to: (a) misreport certain aged trade credits and overstate good will in publicly reported financial statements and other publicly disseminated financial reports (thereby materially overstating earnings); (b) file false and misleading financial statements not prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), despite claiming otherwise; (c) file false and misleading certifications required by the Sarbanes-Oxley Act of 2002 attesting that Insight had adequate internal and financial controls, when it did not; (d) permit material weaknesses to exist in the Company's internal controls over financial reporting; and (e) unlawfully mislead investors as to the accuracy of Insight's financial statements in order to artificially inflate the price of Insight securities during the relevant period, enabling certain company insiders to sell over 2,287,309 million shares of their own personally-held Insight shares for over $49 million in proceeds.

Federal Derivative Action Compl. ¶ 2. Baca alleged that as a result of this misconduct, Insight had been named as a defendant in the Federal Securities Action, was the subject

of an SEC inquiry, had been threatened with delisting by NASDAQ, and had been forced to seek waivers from its lenders. *Id.* ¶¶ 5-6. Baca sought to recover damages on behalf of Insight for these harms. *Id.* ¶ 8.

C. Baca Files An Amended Complaint And Eventually Serves A Section 220 Demand.

On August 5, 2009, Baca filed an amended complaint in the Federal Derivative Action. The new pleading maintained the same theories, but contained more detailed allegations regarding how Insight accounted for aged trade credits. Much of the additional information appears to have been drawn from a May 14 newspaper article in the *Arizona Republic*.

On August 31, 2009, Insight moved to dismiss the Federal Derivative Action pursuant to Federal Rule of Civil Procedure 23.1 for failure to make demand or properly plead demand futility. On September 2, the plaintiffs in the Federal Securities Action moved for a 30-day extension of time to file a consolidated class action complaint, claiming counsel had uncovered "a more widespread and pervasive fraud" by Insight and that additional time was necessary to complete the investigation (the "Motion for Extension"). The Motion for Extension was denied on September 9, and the plaintiffs in the Federal Securities Action filed an amended complaint on September 14.

By letter dated September 9, 2009 (the "Demand Letter"), Baca sought to inspect books and records of Insight pursuant to Section 220. The Demand Letter identified the following purposes:

> Investigating corporate waste, mismanagement or wrongdoing on the part of Insight's officers and directors concerning their oversight of Insight's

> internal controls, phantom sales data, accounting practices, fraudulent revenue recognition, channel stuffing, financial reporting, understated liabilities and improper trade credit accounting during the period commencing in 1996 and continuing through the present date; [Footnote 3] and (ii) Determining whether to expand the scope of my challenge to the misconduct practiced by Insight's officers and directors, as alleged in [the Federal Derivative Action] to reflect recently disclosed evidence of defendants' additional wrong-doing. [Footnote 4]

Footnote 3 of the Demand Letter quoted from the Motion for Extension. Footnote 4 referred to the amended complaint in the Federal Derivative Action. Baca enclosed copies of the Motion for Extension and the amended complaint with his Demand Letter.

Insight rejected the request made in the Demand Letter. Among other reasons, Insight pointed out that it was procedurally improper for Baca to seek books and records *after* filing the Federal Derivative Action.

D. Baca Files An Amended Complaint In The Federal Derivative Action.

Baca did not initially follow up on the Demand Letter. He did not file this action until November 25, 2009, one month after serving the Demand Letter and one week after a November 19 hearing on the Rule 23.1 motion in the Federal Derivative Action, which the Federal Court took under advisement. Even then, Baca did not try to move this case forward. On December 21, Insight moved to dismiss this action, and the parties agreed to a leisurely briefing schedule.

On January 8, 2010, the Federal Court granted the Rule 23.1 motion to dismiss, but gave Baca leave to replead. On February 8, 2010, Baca filed a second amended complaint in the Federal Derivative Action that abandoned the claims relating to aged trade credits and focused on the backdating of stock options.

II. LEGAL ANALYSIS

A complaint will be dismissed pursuant to Rule 12(b)(6) "if it appears with reasonable certainty that the plaintiff could not prevail on any set of facts that can be inferred from the pleading." *King*, 2010 WL 1904972, at *5. Under Section 220(b) of the General Corporation Law, "[a]ny stockholder . . . shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from . . . [t]he corporation's . . . books and records . . . ." 8 *Del. C.* § 220(b). Because of the sequence in which he proceeded, Baca cannot establish a proper purpose for his Section 220 demand.

Baca first filed the Federal Derivative Action and only later served the Demand Letter. By filing the Federal Derivative Action, Baca and his counsel certified that they had sufficient facts to pursue the Federal Derivative Action in good faith and in accordance with the applicable pleading standards. *See, e.g.*, *Taubenfeld v. Marriott Int'l, Inc.*, 2003 WL 22682323, at *3 (Del. Ch. Oct. 28, 2003) ("[P]laintiffs filed their complaint in January 2003. That filing was a certification under Rule 11 that the plaintiffs had enough information to support their allegations."); *Parfi Holding, AB v. Mirror Image Internet, Inc.*, C.A. No. 18457, at 6 (Del. Ch. Mar. 23, 2001) (TRANSCRIPT) ("By filing this plenary action, the plaintiff in the [Section] 220 case has already necessarily conceded that [he] had enough information to file allegations of mismanagement in a complaint with good faith and for its counsel to have satisfied the

necessary pleading standards.") By filing the amended complaint in August 2009, Baca and his counsel repeated those certifications.

The Demand Letter sought to investigate the matters Baca already put at issue in the Federal Derivative Action. The Demand Letter described the wrongdoing to be investigated by referring to the amended complaint in the Federal Derivative Action. The Demand Letter sought the following categories of information:

> 1. All minutes from or anything distributed to or considered by the Board, the Board's Audit Committee, the Board's Compensation Committee, the Board's Executive Committee and the Board's Nominating and Governance Committee that relate to, reflect or discuss the accounting treatment of trade credits, channel stuffing, phantom sales, fraudulent revenue recognition and understated liabilities;
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> 2. All minutes from or anything distributed to or considered by the Board, the Board's Audit Committee, the Board's Compensation Committee, the Board's Executive Committee and the Board's Nominating and Governance Committee that relate to, reflect or discuss intentionally double-billing customer accounts at quarter-end, intentionally shipping high-yield products at quarter-end to customers that had not ordered them, intentionally recording revenue on products that had not yet shipped or that were not available for shipment and intentionally withholding quarter and year-end commissions from Insight's own salespersons and any internal controls to prevent such wrongdoing;
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> 3. The full written report of the findings of the Board's Audit Committee's allegedly independent investigation into accounting and financial control matters completed in connection with Insight's February 9, 2009 announcement that it would restate financial statements;
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> 4. All documents, books and records relied upon by the Board or the Board's Audit Committee, or any member thereof, to file Insight's amended and restated annual financial report on Form 10-K for the fiscal year ended December 31, 2007 and the quarterly reports on Form 10-Q/A for the fiscal quarters ended March 31, 2008, June 30, 2008 and September 31, 2008;

> 5. All documents, books and records that Insight provided to the Securities and Exchange Commission in connection with its investigation of Insight's 2009 earnings restatement;
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> 6. All minutes from or anything distributed to or considered by Insight's Board, the Board's Audit Committee, the Board's Compensation Committee, the Board's Executive Committee and the Board's Nominating and Governance Committee that relate to, reflect or discuss options backdating[; and]
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> 7. All minutes from or anything distributed to or considered by the Board, the Board's Audit Committee, the Board's Compensation Committee, the Board's Executive Committee and the Board's Nominating and Governance Committee that relate to, reflect or discuss the lawsuit *Bernard Apotheker v. Crown et. al.* or any other litigation or threatened litigation arising out of the 2006 allegations of backdating stock options.

Each of these categories related directly to allegations in the amended complaint in the Federal Derivative Action.

For reasons explained thoroughly in *King*, a stockholder does not act with a proper purpose when the stockholder attempts to use Section 220 to investigate matters that the same stockholder already put at issue in a plenary derivative action. *King*, 2010 WL 1904972, at *5. Analyzed at the level of the individual plaintiff, the stockholder who serves a post-plenary-action Section 220 demand contradicts his own certification that he already possessed sufficient information to file a complaint. Analyzed doctrinally, permitting a post-plenary-action Section 220 demand circumvents the substantive legal principles embodied in Rule 23.1. *Id.* at *6. Analyzed systemically, permitting a post-plenary-action Section 220 demand rewards entrepreneurial plaintiffs' lawyers who file quickly to gain control of a derivative case without conducting a meaningful pre-suit investigation. *Id.* at *6-7.

Baca filed the Federal Derivative Action one month after the release of Insight's restated financials and three months after the filing of the Federal Securities Action. Although the pace of filing represented a marginal improvement over times measured in hours or days, Baca's pleading suggested little effort beyond cribbing from the complaints in the Federal Securities Action. Plaintiffs do not act responsibly just by being slower on the draw. They act responsibly by conducting meaningful pre-suit investigations, including by using Section 220 *before* filing a complaint.

It is difficult to see how Insight and its stockholders benefitted from a "fire, ready, aim" approach to the Federal Derivative Action. Because that lawsuit seeks indemnification for losses resulting from the Federal Securities Action, a rational stockholder plaintiff, free of the compulsion to win a first-to-file sweepstakes, would wait until after a ruling on a motion to dismiss the Federal Securities Action before commencing a derivative suit. Prior to a ruling on the motion to dismiss, the Federal Derivative Action imposes additional litigation costs on Insight and its stockholders without any appreciable justification. Because of the automatic stay pursuant to the Private Securities Litigation Reform Act of 1995, Baca would not have lost the ability to participate in on-going discovery in the Federal Securities Action or otherwise risked falling behind by waiting to file. More importantly, a ruling on the motion to dismiss in the Federal Securities Action would have significant ramifications for Baca's derivative claims. The denial of such a motion likely would affect the demand futility analysis. *See Pfeiffer v. Toll*, 989 A.2d 683, 690 (Del. Ch. 2010) ("In light of the federal securities action [which survived a motion to dismiss], it is not possible for the defendants in this

case, who comprised a majority of the Board when the suit was filed, to consider a demand impartially."). The grant of the motion to dismiss, by contrast, would undercut the rationale for the derivative action in the first place. This is not to say that allegations which fail to state a claim under the federal securities laws might not still support a claim for breach of fiduciary duty. But it is to recognize that the dismissal of an underlying securities action should suggest to a rational plaintiff the need for an extensive investigation and detailed pleadings, particularly on the issue of demand futility, before taking the derivative shot.

Absent pressure from a statute of limitations or some other reason meriting prompt filing, one can well question whether a stockholder with a nominal stake who files an indemnification-based derivative action prior to a ruling on a motion to dismiss in the underlying federal securities action and without using Section 220 (or otherwise conducting an independent investigation) is adequately representing the interests of the corporation, as opposed to facilitating the pursuit of economic self-interest by an entrepreneurial law firm. *Cf. King*, 2010 WL 1904972, at *6 n.34 ("Perhaps it is time for the reversal of the traditional presumption in favor of first filers in the derivative suit context."). A stockholder like Baca who invokes Section 220 only after filing such a lawsuit does not have a proper purpose for seeking books and records. *Id.* at *1, 8.

Baca has attempted to distinguish *King* by arguing that he subsequently amended his complaint in the Federal Derivative Action to drop the allegations related to aged trade credits. Baca contends that these issues are therefore not presently in litigation, and he should be permitted to use Section 220 to explore them.

Permitting strategic amendments of this type would reinforce "the perverse incentives motivating too many representative plaintiffs' unseemly and inefficient race to the courthouse" that were described in *King*. *Id.* at *6. Under Baca's proposed regime, a stockholder plaintiff could file a placeholder complaint to secure control of the derivative action, then cleverly use the amendment process to open a window for a subsequent Section 220 investigation.

Section 220 should be used before filing a derivative complaint, not after. Although there are special circumstances under which a Section 220 demand would not be foreclosed by a prior derivative action, none are present here.[1] Baca did not conduct a proper pre-filing investigation. He cannot attempt to remedy that failure through post-filing procedural contortions.

III. CONCLUSION

The motion to dismiss is granted. **IT IS SO ORDERED.**

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[1] *See, e.g., Romero v. Career Educ. Corp.*, 2005 WL 3112001, at *2 (Del. Ch. Nov. 4, 2005) ("The filing of a derivative suit during the pendency of a § 220 action does not necessarily extinguish all proper purposes. . . . When the overlap in suits results from a defendant's failure to comply with its § 220 obligations, the filing of a derivative complaint will not make an otherwise proper purpose improper."); *Khanna v. Covad Commc'ns Group, Inc.*, 2004 WL 187274, at *3 (Del. Ch. Jan. 23, 2004) (explaining that a stockholder who filed a Section 220 demand and subsequently brought a derivative action due to the likelihood that his derivative claims might otherwise become time barred was not stripped of his previously-proper purpose, since the sequence of events was due to the company's – rather than the stockholder's – choices). Future cases may present other appropriate circumstances, such as a desire to explore unrelated matters not put validly at issue in the pending derivative action.