IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

MAX COHEN, Plaintiff, EL PASO CORPORATION, a Delaware corporation, Defendant.	)	C.A. No. 551-N

MEMORANDUM OPINION

Submitted: September 13, 2004
Decided: October 18, 2004

Elizabeth M. McGeever, of PRICKETT, JONES & ELLIOTT, P.A., Wilmington, Delaware; OF COUNSEL: Sherrie R. Savett and Glen L. Abramson, of BERGER & MONTAGUE, P.C., Philadelphia, Pennsylvania, Attorneys for Plaintiff.

Donald J. Wolfe, Jr., Arthur L. Dent and Joseph B. Cicero, of POTTER ANDERSON & CORROON LLP, Wilmington, Delaware, Attorneys for Defendant.

CHANDLER, Chancellor

The question before the Court is whether a shareholder action to inspect certain books and records of a corporation should be stayed or dismissed when, pursuant to federal law, discovery has been stayed in a suit involving the same defendant corporation and a shareholder class in which the plaintiff is a purported member? For reasons explained in detail later, I conclude that the state books and records action may proceed as the federal law is not in conflict with the state books and records action and the shareholder has alleged a proper purpose.

I. BACKGROUND FACTS

Defendant El Paso Corporation ("El Paso"), a Delaware corporation with its principal place of business in Houston, Texas, is a global energy company. Its operations include natural gas production, extraction, and power generation. Plaintiff Max Cohen has continuously been the beneficial owner of 200 shares of El Paso stock since June 4, 2002.[1] On June 9, 2004, pursuant to 8 *Del. C.* § 220, Cohen served a written demand on El Paso to inspect certain books and records to investigate possible waste and mismanagement.[2] His demand sought documents relating to "El Paso's accounting for oil and gas reserves, the severance package of former CEO

[1] Compl., ¶ 1.
[2] *Id*.

William A. Wise, and the independence of El Paso's Board of Directors and Audit Committee."[3]

On July 18, 2002, *Goldfarb v. El Paso*, a class action complaint alleging violations of federal securities law, was filed in the United States District Court for the Southern District of Texas, Houston Division.[4] On April 28, 2004, *Goldfarb* and other cases were consolidated into *Oscar S. Wyatt, Jr. v. El Paso Corp.*[5] The *Wyatt* complaint includes the following allegations:

> During the Class Period, El Paso and its top executives inflated the prices of El Paso securities by making materially false and misleading SEC filings and statements which: (1) exaggerated gross revenues by at least $800 million due to phony "round trip" trading; (2) inflated revenues and earnings by misuse of "mark to market" accounting; (3) hid more than $1 billion of liabilities and another $1 billion of guarantees associated with off-balance sheet companies controlled by El Paso; (4) falsely attributed El Paso's success to legitimate business practices when, in fact El Paso manipulated the California energy market; and (5) overstated the Company's proved oil and natural gas reserves by more than 40%, thereby causing a material overstatement of its income.[6]

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[3] *Id.* at Ex. A, Demand for Inspection of Books and Records Pursuant to 8 *Del. C.* § 220 and Del. Common Law.

[4] Pl.'s Br. in Opp. to Def. El Paso Corp's. Mot. to Dismiss or, Alternatively, for a Stay, at 4-5.

[5] C.A. No. H-02-2717.

[6] Compl., *Wyatt v. El Paso Corp.,* C.A. No. H-02-2717 at 1. Count IV of that complaint also includes an extensive discussion of the defendants' motives to participate in and encourage the alleged fraudulent conduct, including defendant and former CEO William A. Wise. *Id.* at 32-36.

After being consolidated, defendants in the Texas action have filed a motion to dismiss. As a result of the motion to dismiss, discovery in *Wyatt* was automatically stayed pursuant to the Private Securities Litigation Reform Act of 1995 ("PSLRA").[7]

El Paso has moved to dismiss or stay plaintiff's § 220 complaint because it conflicts with the discovery stay issued in *Wyatt*, a class in which Cohen is a purported member,[8] and is therefore for an improper purpose.

II. ANALYSIS

The issue before me today is not whether plaintiff has pled sufficient facts to state a legal claim, but whether plaintiff's avowed purpose for his books and records action is improper as a result of the PSLRA and the Securities Litigation Uniform Standards Act ("SLUSA").[9]

A. Plaintiff's § 220 Complaint

Section 220 allows a shareholder, upon written demand and a showing of proper purpose, access to a corporation's stock ledger, a list of

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[7] 15 U.S.C. § 77z-1(b)(1) ("In any private action arising under this subchapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds, upon the motion of any party, that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.").

[8] The class has not yet been certified.

[9] 15 U.S.C. § 77z-1(b)(4), § 78u-4(b)(3)(D)("Upon a proper showing, a court may stay discovery proceedings in any private action in a State court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this subsection.").

stockholders, and its other books and records. Both the Court of Chancery and the Delaware Supreme Court have repeatedly admonished shareholder plaintiffs to seek books and records before filing class or derivative complaints, so that they may prepare a factually accurate and legally sufficient pleading.[10] Both Courts have also recognized that shareholder plaintiffs who use § 220 often avoid the "expensive and time-consuming procedural machinations that too often occur in derivative litigation."[11]

Typically, plaintiffs who file a § 220 action are challenged on the grounds of either improper purpose or that they are not a beneficial shareholder.[12] In a § 220 action, the shareholder must make a credible showing of purpose "through documents, logic, testimony or otherwise, that there are legitimate issues of wrongdoing."[13] Somewhat out of the ordinary, El Paso challenges plaintiff's § 220 complaint by arguing that it is in direct conflict with the stay of discovery in *Wyatt* issued pursuant to the PSLRA, and therefore the plaintiff, in bad faith, is trying to circumvent the federal

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[10] *See Guttman v. Jen-Hsun Huang,* 823 A.2d 492, 493-494, 504 (Del. Ch. 2003).
[11] *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275, 279 n.5 (Del. Ch. 2003).
[12] *See Thomas & Betts Corp. v. Leviton Mfg. Co.,* 681 A.2d 1026 (Del. 1996). *See also Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom, Inc.,* 2004 WL 1945546 (Del. Ch.); *Freund v. Lucent Technologies, Inc.,* 2003 WL 139766 (Del. Ch.).
[13] *Security First Corp. v. United States Die Casting & Dev. Co.,* 687 A.2d 563, 568 (Del. 1997).

policy expressed in the PSLRA and SLUSA. El Paso's argument, in effect, challenges Cohen's purpose for filing the § 220 action.

Despite El Paso's contention, nothing on the face of the complaint demonstrates or even suggests that Cohen's § 220 action has an improper purpose. Rather, as a shareholder, Cohen seeks to investigate possible waste and mismanagement. Cohen filed his § 220 action after El Paso publicly announced a $1 billion write-down as a result of improper accounting for proved reserves. Additionally, the SEC launched a formal investigation into El Paso's accounting practices. Both of these incidents provide a credible basis upon which Cohen alleges a proper purpose in investigating waste and mismanagement.[14] Cohen seeks inspection of books and records in three separate areas: (1) El Paso's accounting for oil and gas reserves; (2) the severance package of former CEO William A. Wise; and (3) the independence of El Paso's Board of Directors and Audit Committee.[15] The books and records that Cohen seeks relate directly to claims of waste and mismanagement and they will aid Cohen in determining whether he may

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[14] A shareholder is not required to show actual mismanagement or waste, rather they must "present some credible basis from which the court can infer that waste or mismanagement may have occurred." *Security First*, 687 A.2d at 568-569 (quoting *Thomas & Betts Corp.,* 681 A.2d at 1031).

[15] Compl., at Ex. 1.

assert a legally sufficient claim. Cohen's avowed purpose for the § 220 action is clearly proper.

Nevertheless, El Paso has expressed concern that Cohen, in bad faith, is attempting to avoid the stay of discovery in *Wyatt* by seeking discovery in Delaware via this books and records action. El Paso argues that to allow Cohen to bring a books and records action would allow him to undermine the PSLRA order in *Wyatt*, and thereby allow those parties subject to the stay of discovery to proceed with discovery and circumvent the PSLRA. Although the Court will not allow a party to proceed with a § 220 action if it is brought in bad faith, nothing in this proceeding suggests that Cohen is acting in bad faith. The class in *Wyatt* remains uncertified, and while Cohen may find himself a member of the eventually certified class, he currently is not. Furthermore, there is no indication that Cohen has ties to the plaintiffs in *Wyatt* so as to suggest an intention to turn over information obtained through discovery to them. Cohen's counsel, for example, are not connected to counsel in *Wyatt*, or otherwise involved in the *Wyatt* litigation. Lastly, concern about plaintiff's motives for seeking books and records are answered by plaintiff's willingness to enter into a confidentiality agreement for material obtained in this case until the motion to dismiss in *Wyatt* has been resolved. In short, nothing supports El Paso's assertion that Cohen is

attempting to aid the plaintiffs in *Wyatt* and thereby undermine the PSLRA's automatic stay of discovery.

B. PSLRA and SLUSA

The PSLRA is aimed at reducing abusive litigation practices in federal securities class actions, and automatically stays discovery when a defendant in the class action files a motion to dismiss.[16] SLUSA provides that "upon a proper showing, a court may stay discovery proceedings in any private action in a State court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to [the PSLRA]."[17] Where the PSLRA automatically stays discovery in federal securities class actions once a motion to dismiss has been filed, SLUSA prevents plaintiffs from avoiding the PSLRA's mandated stay of discovery by fleeing to state court.

The Senate determined that discovery often amounts to an abusive practice in that it ties up key employees through document preparation and depositions, often amounts to more than 80% of litigation expenses, and can be so prohibitively expensive that it may force one party to settle.[18] Additionally, the Senate observed that plaintiffs sometimes use discovery as

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[16] *See* 15 U.S.C. § 77z-1(b)(1); *see also H.R. Conf. Rep. No.* 104-369 (1995).
[17] 15 U.S.C. § 77z-1(b)(4), § 78u-4(b)(3)(D).
[18] *See* S. Rep. 104-98 at 14.

a fishing expedition, first filing frivolous lawsuits and then using the discovery process to try to muster sufficient evidence to support a sustainable claim.[19] In essence, the goal of the PSLRA is to temporarily stay discovery once a motion to dismiss is filed in order to allow the parties to come to a conclusion on the motion free from the weight of potentially costly, and possibly wide-ranging discovery.

El Paso argues that the effect of the PSLRA and SLUSA is to preempt this Court from hearing Cohen's § 220 action on its merits. This argument is a non-starter. Federal preemption of state law may be explicit, or "implicitly contained in [the] structure or purpose" of a federal statute.[20] Furthermore, state law may be preempted if it directly conflicts with federal law,[21] or if the federal law so occupies the field of regulation as to imply that Congress left no room for state legislation.[22] Courts focus on the intent of Congress when determining whether a state law has been preempted,[23] and

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[19] *Id.*
[20] *Jones v. Rath Packing Co.,* 430 U.S. 519, 525 (1977). *See also Pacific Gas & Elec. Co. v. State Energy Resources Conservation and Development Comm.,* 461 U.S. 190, 203-204 (1983); *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers,* 514 U.S. 645, 654 (1995).
[21] *See Pacific Gas & Elec. Co.,* 461 U.S. at 204.
[22] *See Fidelity Savings & Loan Assn. v. De la Cuesta*, 458 U.S. 141, 153 (1982).
[23] *See Cipollone v. Liggett Group, Inc.,* 505 U.S. 504, 516 (1992).

courts begin their review with the presumption that Congress did not intend to preempt state law.[24]

As the text and legislative history of both the PSLRA and SLUSA reveal, the automatic stay of discovery provisions were meant to deal exclusively with discovery in federal securities class actions. Neither the PSLRA nor SLUSA prevents a state court from considering a books and records demand, or similar state corporate law claims, merely because one of the parties to the state action is protected by a PSLRA automatic discovery stay in an unrelated federal securities class action. Conflict between the PSLRA with § 220 will potentially arise only when the § 220 action is seeking records that pertain directly to a federal securities law claim asserted in a pending federal action, and that is not the case here. Cohen's complaint, while relying on similar, if not identical facts, as form the basis for the federal securities law claims in *Wyatt*, seeks to investigate state law claims of waste, mismanagement and breach of fiduciary duty. These are traditional state law claims, and are not the subject of the *Wyatt* litigation. Therefore, neither the PSLRA nor SLUSA operate to preempt or otherwise interrupt Cohen's § 220 action.

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[24] *New York State Conference of Blue Cross & Blue Shield Plans*, 514 U.S. at 614. *See also Maryland v. Louisiana,* 451 U.S. 725, 746 (1981).

III. CONCLUSION

El Paso has failed to demonstrate that Cohen filed his § 220 action for an improper purpose. Nor has El Paso demonstrated that Congress intended the PSLRA or SLUSA to preempt state corporate law, in particular shareholder actions to inspect books and records. El Paso's motion to stay or dismiss is denied.

IT IS SO ORDERED.