

STATUTORY RECORDS REQUESTS: CAN A REQUEST BE MADE AFTER A LAWSUIT IS FILED?

In Texas, a qualifying shareholder of a corporation or a member of a limited liability company has the right to examine the company's books and records for a proper purpose. This right is provided in the Texas Business Organizations Code. A request to examine records under this law is usually made before any lawsuit is filed to investigate whether officers or members have misused company property or engaged in self-dealing. The right to examine books and records may be enforced by a court action. Once a lawsuit is filed, discovery of documents is usually governed by rules of civil procedure that impose limitations on what documents are discoverable. But, the rules of civil procedure do not expressly prohibit the use of a statutory requests outside of the lawsuit, nor does the Business Organizations Code expressly prohibit the use of a statutory request after a lawsuit has been filed. There is little guidance from Texas courts on whether a statutory records request may be made after suit is filed. However, one recent federal case shot down a statutory records request after suit was filed. The takeaway from this dearth of authority and one federal case is the best course would be to make any statutory records request *before* a suit is filed to avoid the limitations placed on discovery in lawsuits.

Statutory Records Requests

In Texas, a request for books and records of a corporation or a limited liability company is governed by the Texas Business Organizations Code. A shareholder who has held shares for at least 6 months or owns 5% of the corporation's outstanding shares is entitled to examine and copy a "corporation's books, records of account, minutes, and share transfer records[.]" Tex. Bus. Orgs. Code § 21.218(b). Similarly, a member of a limited liability company may request to examine or copy various records and "information regarding the business, affairs, and financial condition" of a limited liability company. Tex. Bus. Orgs. Code § 101.502(a).

The right to examine books and records under the Code is not absolute. It must be made for a "proper purpose." If the company disputes the purpose and refuses to produce the books and records, the requesting party may filed a lawsuit to compel production. Once a dispute over the purpose is raised in pleadings in the lawsuit, the issue must be tried to a jury, if one is requested. *Uvalde Rock Asphalt Co. v. Loughridge*, 425 S.W.2d 818, 820 (Tex. 1968). This can result in a significant delay.

The Code provides defenses to a statutory request, including that the requesting party has improperly used information obtained through a prior examination, and that the requesting party did not act in good faith or have a proper purpose in making the request. Tex. Bus. Orgs. Code § 21.222(b); 101.503(b). The Code also requires the company to pay the requesting party's costs and attorney's fees if it is compelled to produce records. *Id.* at § 21.222(a); 101.503(a). Given the potential liability for attorneys fees, companies who are properly advised treat statutory records requests seriously.

Litigation Records Requests

When a lawsuit is filed, requests for records in the course of the lawsuit are governed by the Texas or Federal Rules of Civil Procedure, which have almost identical procedures and limitations. Texas Rule 196 permits a party to a lawsuit to serve on another party a request for documents that must describe the documents with reasonable particularity. Similarly, Texas Rule 176a permits a party to serve on a non-party a request for documents with a subpoena. The rules of civil procedure permit a responding party to object to the request, or seek protection if the request calls for information that is privileged, not relevant, or responding to the request will impose undue burden. The rules of procedure do not parallel the procedure provided in the Business Organizations Code. The Code does not on its face protect privileged information, nor does it protect against requests for information that might not be relevant to a claim in a lawsuit or that are unduly burdensome. Therefore, due to the differences in the procedures and the limitations between the Code and the rules of civil procedure, it is important to consider whether to make a statutory records request before a lawsuit is filed and to understand whether a statutory records request is even available after suit is filed.

A Death of Authority—Save Nerium Int'l, LLC

There are no Texas state court opinions answering the question of whether a statutory records request may be made after a lawsuit is filed. The absence of authority leaves many related questions unanswered. For example, should the rules of procedure on discovery apply when a statutory records request is made during the pendency of a lawsuit, or does the Code preempt the rules of procedure? Conversely, can the company resist a litigation records request on statutory grounds and demand a jury trial on whether the purpose of the request was proper (which could take months or years)?

Fortunately, one federal case in Dallas has addressed the central issue. In *Nerium SkinCare, Inc. v. Nerium Int'l, LLC*, 3:16-CV-1217-B, 2017 WL 9471419, at *1 (N.D. Tex. Apr. 5, 2017), United States District Court Judge Jane Boyle, of the Northern District of Texas, was presented with the central question of whether a statutory records request could be made after suit is filed. In *Nerium*, a member of a limited liability company made a statutory records request, stating its purpose to, among other things, “investigate accounting irregularities and suspected self-dealing.” *Id.* Litigation was already pending when the request was made to the company. After the request was denied, the member amended its complaint to add a cause of action seeking to compel the inspection. *Id.* Then, the member filed a motion to compel the demanded inspection, prior to any trial on the merits regarding whether the member had a proper purpose. *Id.* The member made the argument to Judge Boyle that the statutory records request is “independent of any discovery mechanism in this case and is limited only by the requirement that the request be for a ‘proper purpose.’” *Id.* Importantly, the records sought by the member under the Code were clearly related to the underlying dispute. *Id.*

Judge Boyle was not persuaded, noting that “Plaintiffs have pointed the Court to no cases—from this district or any other—where a federal district court has ordered a statutory books and records request when litigation was already pending regarding the same issues forming the basis of the books and records request.” *Id.* at *2. Further, she stated that, since she could find no Texas cases on point, she would look to the Delaware courts for guidance, as is customary for Texas courts deciding corporate matters. *Id.* Upon reviewing relevant Delaware authority, Judge Boyle opined that the clear weight of authority favored making the records request prior to initiating litigation, because, once a lawsuit has been filed, an inference can be drawn that the plaintiff possessed sufficient information to substantiate his claims without the need for additional records. *Id.* In other words, once the requester has filed suit, he no longer needs the information available under the Code and cannot claim to have a proper purpose in making the request. Further, once litigation has begun, procedural mechanisms are in place to allow plaintiffs to obtain the requested documents and, in this instance, the member acknowledged that the documents it was seeking were also available pursuant to the normal discovery process. *Id.* Therefore, Judge Boyle denied the member’s motion to compel the statutory inspection. *Id.*

The takeaway from *Nerium* is that a post-suit statutory records request may be treated differently than a pre-suit request when the request concerns the matters being litigated. One of the primary functions of the Code is to afford shareholders and members the ability to investigate misconduct and self-dealing, which oftentimes leads to a lawsuit. But, once the lawsuit has been filed, the relevant rules of procedure will likely govern the exchange of records. However, it is possible that a statutory records request could be successfully made during the pendency of litigation for the purpose of discovering matters that are not related to underlying litigation. In that situation, the reasoning in *Nerium* will not apply, because the information sought by the requester would not be available in discovery as it is not relevant to the case.

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