

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

JAKKS PACIFIC, INC.,)
)
 Plaintiff,)
)
 v.) C.A. No. 4295-VCL
)
 THQ/JAKKS PACIFIC, LLC, and)
 THQ, INC., as operator and custodian of)
 records of THQ/JAKKS PACIFIC, LLC,)
)
 Defendants.)

MEMORANDUM OPINION AND ORDER

Submitted: April 27, 2009

Decided: May 6, 2009

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LAMB, Vice Chancellor.

Two co-adventurers formed a limited liability company to obtain and exploit a videogame license from a sports-entertainment franchise. One member agreed to obtain the license in return for a royalty-like payment based on the stream of future revenues. The other agreed to operate the enterprise and bear the risk of profits or losses after payment of the royalty. The term of the license agreement is nearing its end and relations between the first member and the licensor have deteriorated, threatening the possibility of renewal. The non-operating member now brings a broad books and records action against the joint venture, claiming a variety of proper purposes to justify its sweeping demand. The issue after trial is whether any of the claimed purposes find support in the fact record. For the following reasons, the court finds no proper purpose to support the demand of books and records and will enter judgment in favor of the defendant entity.

I.

A. The Parties

The plaintiff, JAKKS PACIFIC, Inc. (“JAKKS”), is a Delaware corporation with its principal place of business in Los Angeles, California. JAKKS designs, develops, produces, and markets toys under a variety of different brands. JAKKS is one of the two members of THQ/JAKKS.

Defendant THQ/JAKKS PACIFIC, LLC (“THQ/JAKKS”) is a Delaware limited liability company formed to develop, manufacture, distribute, market, and

sell wrestling-based videogames pursuant to a license from World Wrestling Entertainment (“WWE”). THQ/JAKKS exists as a joint venture of JAKKS and THQ.

Defendant THQ, Inc. is a Delaware corporation, with its principal place of business in Agoura Hills, California. THQ is a developer and publisher of videogame software for both videogaming consoles and personal computers. THQ is the second member of THQ/JAKKS and pursuant to the LLC Agreement is responsible for the day-to-day operations of the THQ/JAKKS business.

B. The Litigation

JAKKS filed a complaint seeking inspection of books and records of THQ/JAKKS, pursuant to Section 18-305 of the Limited Liability Company Act,¹ on January 16, 2009. THQ/JAKKS timely filed its answer on February 10, 2009. A one-day trial was held on March 31, 2009. Post-trial briefing concluded on April 27, 2009.

C. Facts

On June 10, 1998, WWE granted a videogame license to THQ and JAKKS. In connection with the grant of that license, THQ and JAKKS formed THQ/JAKKS. On October 25, 1999, JAKKS and THQ executed the LLC Agreement for THQ/JAKKS, which was later amended in 2002 and 2004.

¹ 6 *Del. C.* § 18-305.

Under the LLC Agreement, THQ is responsible for all day-to-day operations and maintains all financial and operational records of THQ/JAKKS. JAKKS has no capital invested in the joint venture,² nor does JAKKS have any residual equity interest in the joint venture. Instead, pursuant to the LLC Agreement, JAKKS is entitled to a “Preferred Return,” the percentage rate for which is reset each distribution period. The Preferred Return is a fixed percentage of top-line sales revenue (less a fixed reserve for returns and price protection), with a minimum guaranteed amount regardless of revenues achieved. In the initial distribution period, which ran from the execution of the LLC Agreement in October 1999 to June 30, 2006,³ the Preferred Return was fixed by contract at approximately 10%.

The LLC Agreement provided that the Preferred Return for subsequent distribution periods would be set by the parties based on historical and projected sales and profit data, such that the Preferred Return would approximate 49% of the anticipated net profits of the joint venture during the distribution period. Although income of the joint venture was to be allocated first to JAKKS, up to the amount of the Preferred Return, that is JAKKS’s only claim on the income of the firm. All income above the Preferred Return belongs entirely to THQ, and THQ bears all of

² Although JAKKS initially invested \$1 million of the \$2 million paid to WWE to obtain the videogame license, THQ was required under the LLC Agreement to reimburse JAKKS for its \$1 million contribution.

³ The LLC Agreement originally provided for the initial distribution period to run through December 31, 2003. The parties amended the agreement, however, to extend the initial distribution period out to June 30, 2006.

the risk of loss. Thus, JAKKS's economic interest in the joint venture, though it is technically a member of the LLC, is less that of an equity owner and more akin to a licensor with rights to royalties based on sales.⁴

The current distribution period began July 1, 2006 and ends December 31, 2009. The Preferred Return rate for this period has not yet been established. Because the parties were unable to arrive at an agreement as to the Preferred Return, the issue was presented to an arbitrator for decision, as the LLC Agreement requires. Extensive discovery was taken during the course of that arbitration. The arbitration hearing was completed shortly before the instant matter came to trial, and the parties are now awaiting the arbitrator's decision. Until the arbitrator makes his decision, no Preferred Return payments can be made from the joint venture to JAKKS for the current distribution period. In the interim, JAKKS has continued to accrue the Preferred Return as revenue at the 10% rate of the initial distribution period.

⁴ See LLC Agreement § 10, which reads:

Profits and Losses. Income of the Joint Venture for any fiscal year will be allocated 100% to JAKKS Pacific to the extent any Preferred Return is distributed, accrued or distributable for such fiscal year. Losses shall be allocated in accordance with membership interests for so long as JAKKS has a positive capital account and thereafter shall be allocated solely to THQ. All remaining income of the Joint Venture for any fiscal year will be allocated to THQ. Notwithstanding any other provision of this Agreement, JAKKS Pacific shall not have any liabilities or obligations to THQ or the Joint Venture with respect to any deficits in the capital accounts of the Joint Venture or any adjustments thereto.

Because JAKKS's capital account with respect to the LLC is zero, losses are allocated solely to THQ.

The WWE license will expire on December 31, 2009. THQ/JAKKS has the option, however, under the terms of the license agreement to extend that license for an additional five-year period if the joint venture is not in default of any material term of the agreement. Although THQ/JAKKS has not yet exercised its option to extend, JAKKS contends that there is no reason that the joint venture would not extend the license. This contention ignores WWE's suit against THQ/JAKKS for breach of contract. Moreover, WWE has sued JAKKS alleging bribery of its agents in procuring licenses from WWE. Additionally, WWE, stating that it believes JAKKS "hinders" rather than "aids" the performance of the videogame license, has unilaterally chosen to eliminate JAKKS's role from the videogame approval process and deal exclusively with THQ.⁵ Thus, any future extension of the WWE license is highly speculative. Because the current distribution period is coterminous with the license period, any future distribution period is equally speculative.

THQ maintains its accounting records through use of a high-end SAP accounting system, which is audited by the well-known accounting firm of Deloitte & Touche. Deloitte & Touche has never expressed an opinion other than an unqualified one with respect to its audits of THQ, and has never identified any material weaknesses with respect to THQ's financial reporting systems.

⁵ See DX24; DX25. JAKKS's primary responsibility under the LLC Agreement is to manage the relationship between the joint venture and WWE. LLC Agreement §§ 12(b) & (g).

Rather than keep a separate general ledger for the joint venture, THQ maintains the records for the joint venture as part of its own general ledger. To aid it in this (and in support of its accounting activities generally), THQ uses the Oracle Hyperion product, which allows users to more easily query data from the SAP system and to extract that data in a more meaningful way. Through Hyperion, THQ can query all relevant accounting data relating to any particular videogame SKU.⁶ To aid it in managing the business, THQ regularly prepares detailed contribution margin statements that show direct revenues and expenses associated with each SKU. THQ is also able to prepare “P&L” statements for each SKU by layering overhead costs, which are allocated across multiple products according to some appropriate methodology, on top of the contribution margin statement for the respective SKU. THQ can then aggregate the P&L across all of the SKUs associated with the joint venture to obtain an aggregate P&L statement for THQ/JAKKS.

As part of the performance of its obligations under the LLC Agreement, THQ contracts with Yuke’s Company Limited to develop the games for the joint venture. Yuke’s, a publicly traded Japanese company engaged in the business of videogame development, has also been the developer of some of THQ’s non-joint venture titles. All of Yuke’s activities on behalf of THQ have been conducted

⁶ A SKU represents a particular videogame title on a particular platform.

pursuant to development agreements between THQ and Yuke's, copies of which have been provided to JAKKS.

In 2000, THQ purchased in a private placement, for approximately \$5 million, 388,000 shares of the common stock of Yuke's. As part of that transaction, Yuke's also agreed, for a period of time, to produce wrestling games for the Playstation consoles exclusively for THQ.

D. The Inspection Demand

In March 2008, JAKKS sent THQ a letter demanding a broad spectrum of financial documents related to the joint venture. THQ responded with a production of over 110,000 pages of information. As part of that production, THQ provided total summary P&L statements for the joint venture's products from 1999 to 2008 and schedules showing the allocation to the joint venture of certain THQ-wide overhead expenses. THQ also produced contribution margin statements for each game produced by the joint venture from inception through December 2008. THQ later updated its production of P&L statements and included forecast data. JAKKS then made a number of follow-up requests, including a request for contribution margin statements broken down both by year and, later, by quarter. Responses to these requests were provided by THQ. The scope of this production was negotiated by counsel for the parties and supervised by the arbitrator charged with determining the Preferred Return rate for the current distribution period.

JAKKS sent its current books and records demand on December 26, 2008, citing its right of inspection under the Delaware Limited Liability Company Act. That demand asked for an even more extensive list of items than had been demanded or produced as part of the arbitration, including a number of items that did not actually constitute books and records of the joint venture.⁷ JAKKS stated that it required these materials in order to:

- (a) determine the true status, financial condition and value of the LLC;
- (b) verify THQ's proper accounting for LLC funds held in trust for LLC members, including the [P]referred [R]eturn due to JAKKS;
- (c) investigate THQ's possible failure to adequately and accurately maintain the LLC's books and records;
- (d) investigate THQ's possible mismanagement of the finances of the LLC and breach of duties owed to the LLC and JAKKS;
- (e) investigate THQ's possible breaches of duty in connection with its development of a competing videogame based on wrestling under a license issued by . . . UFC;
- (f) investigate THQ's possible breaches of duty in connection with contracts it entered into with Yuke's and communications it had with WWE;

⁷ For example, “[a]ll documents concerning THQ’s proposed development, manufacture, distribution and sale of a videogame under a license of Ultimate Fighting Championship (“UFC”) and all financial records reflecting the actual and expected profits earned or expected to be earned by THQ pursuant to said license.” DX4 ¶ 4. JAKKS also demands all documents reflecting any communications between Yuke’s and THQ, any agreements between THQ and Yuke’s, any payments to Yuke’s or investments in Yuke’s by THQ, and any financial transactions between THQ and Yuke’s, all from 1999 onward. *Id.* ¶¶ 5-7, 9. In apparent recognition that at least some of the items demanded are not actually books and records of the LLC, JAKKS separately demands documents and records of all financial transactions between the joint venture and Yuke’s. *Compare id.* ¶ 8 with *id.* ¶ 9.

(g) determine the extent of the damage that may have been caused to the LLC, and through it, to JAKKS as a member of the LLC, as a result of THQ's possible failure to properly maintain and manage the LLC's day-to-day operations, including its books and records.⁸

On January 9, 2009, THQ's counsel responded by letter to JAKKS's demand. The letter stated that JAKKS's demand was (1) overbroad and unreasonably burdensome, and (2) failed to state a "proper purpose."⁹ Nevertheless, THQ offered, in order to be done with the matter, to make a limited production of documents, subject to JAKKS's agreement to certain conditions. On January 14, 2009, JAKKS's counsel responded by letter. The response generally refused the terms of THQ's offer. JAKKS filed this suit two days later to enforce its rights under 6 *Del. C.* § 18-305.

II.

In its post-trial briefs, JAKKS essentially offers three purposes for which it needs the demanded documents: (1) to aid it in negotiating the Preferred Return for the next distribution period, (2) to value its interest in the LLC, and (3) to investigate alleged mismanagement and wrongdoing by THQ in managing the affairs of the joint venture. Because the first two offered purposes are, in this case,

⁸ DX4 at 2.

⁹ DX17 at 1 (citing *Somerville S Trust v. USV Partners, LLC*, 2002 WL 1832830, at *5 (Del. Ch.) ("[F]or inspection relief to be granted, the plaintiff must first establish by a preponderance of the evidence the existence of a 'proper purpose' for inspection.")).

meaningless or highly speculative, and the last purpose is unsupported by the facts, the court determines that JAKKS has failed to demonstrate a proper purpose for its demand.

Section 18-305 of the Delaware Limited Liability Company Act provides:

(a) Each member of a limited liability company has the right . . . to obtain from the limited liability company from time to time upon reasonable demand *for any purpose reasonably related to the member's interest as a member of the limited liability company*:

(1) True and full information regarding the status of the business and financial condition of the limited liability company;

* * *

(6) Other information regarding the affairs of the limited liability company as is just and reasonable.¹⁰

Thus, this court has held, “the plaintiff must first establish by a preponderance of the evidence the existence of a ‘proper purpose’ for inspection.”¹¹ Such a purpose cannot simply be proper in the abstract, but must be reasonably related to the specific interest of the member making the demand.

JAKKS first states that it needs the demanded materials to aid it in negotiating the Preferred Return for the next distribution period. However, the current distribution period ends at the same time as the WWE license. Given the

¹⁰ Emphasis added. Although the language of Section 18-305 is subtly different from Section 220 of the Delaware General Corporation Law, 8 *Del. C.* § 220, this court has generally treated the two as *in pari materia*. See, e.g., *Somerville*, 2002 WL 1832830, at *5 n.4 (stating that “the Court may look to cases interpreting similar Delaware statutes concerning corporations and partnerships” in order to interpret Section 18-305).

¹¹ See *Somerville*, 2002 WL 1832830, at *5 (citing *Sec. First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 567 (Del. 1997)).

tenor of the relationship between JAKKS and WWE and the ongoing litigation between WWE and the joint venture, there is substantial uncertainty that the joint venture will be able to renew the WWE license. Thus, any future distribution period is entirely speculative. If the joint venture is later able to extend the license, a books and records demand might then be appropriate. But at present, a demand in order to satisfy a purpose so disconnected from the likely course of events is not “reasonably related” to JAKKS’s interest in the LLC.

JAKKS next suggests that it needs the demanded documents in order to value its interest in the LLC. Although in most circumstances that might generally qualify as a valid purpose for a demand, here it is largely meaningless.¹² JAKKS has no residual equity interest. Rather, JAKKS has the right only to the Preferred Return. The Preferred Return for the prior distribution period has already been paid. For the current period, the Preferred Return has been the subject of arbitration, and the parties expect the outcome of that arbitration at any time. Thus the value of JAKKS’s interest in the LLC is simply the present value of the Preferred Return for the current distribution period, which will end on December

¹² See *Somerville*, 2002 WL 1832830, at *8 (citing *Macklowe v. Planet Hollywood, Inc.*, 1994 WL 560804, at *4 (Del. Ch.); *Ostrow v. Bonney Forge Corp.*, 1994 WL 114807, at *7 (Del. Ch.)) (“It is undisputed that valuing a member’s interest is a proper purpose under Delaware law.”). In *Somerville*, however, the plaintiff held membership units which represented true equity interests in the LLC. The court by no means holds here that, as a matter of law, the member must have an actual equity interest in the LLC in order for valuation to be a proper purpose. But there must be something non-illusory to value in order for valuation to be a proper purpose.

31, 2009. Once the arbitrator determines the Preferred Return rate for the current distribution period, calculation of the “value” of JAKKS’s interest will be a matter of simple arithmetic, and will require no more than the sales figures and forecasts already in JAKKS’s possession. Thus, production of further documents cannot reasonably serve the purpose of valuing JAKKS’s interest in the LLC.

Lastly, JAKKS claims it needs the demanded documents in order to investigate mismanagement by THQ. To support an allegation of mismanagement, a plaintiff in a Section 18-305 action must offer a credible basis to suspect mismanagement or wrongdoing.¹³ JAKKS has failed to do so.

In support of its case, JAKKS offered two witnesses. The first witness, Joseph Anastasi, CPA, is a litigation consultant brought in by JAKKS after it had already filed its complaint in order to raise questions about the accounting documents provided by THQ to JAKKS during the course of the arbitration. Whatever credence the court might have given Anastasi’s analysis disintegrated during cross-examination, when it became obvious to the court that the elaborate trial exhibit Anastasi had prepared to illustrate “variances” he claimed to find in THQ’s accounting data was utterly unreliable.¹⁴

¹³ See *Sec. First Corp.*, 687 A.2d at 568 (citing *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026, 1031 (Del. 1996)); see also *Brehm v. Eisner*, 746 A.2d 244, 267 n.75 (Del. 2000) (stating that “a party needs to show, by a preponderance of the evidence, that there is a legitimate chance that their reason for suspecting mismanagement is credible”).

¹⁴ For example, Anastasi compared half-year numbers in one dataset with full-year data in another and claimed that the difference was evidence of accounting weaknesses. Allegations

JAKKS's second witness, Michael Dwyer, is general counsel of JAKKS. Dwyer's testimony on the subject of mismanagement consisted mainly of self-serving, but unsupported, allegations of THQ usurping the relationship with WWE, and supposed conflicts of interest relating to THQ's relationship with Yuke's for both joint venture and non-joint venture projects. However, the fact that, as a result of the deterioration of the relationship between JAKKS and WWE, THQ picked up the role of primary liaison to WWE, without more, provides no credible basis to believe that THQ has breached any of its duties under the LLC Agreement. Similarly, JAKKS offered nothing to give the court any credible basis to infer that THQ may have breached its fiduciary duty to the joint venture by its relationship with Yuke's.

III.

For the reasons set forth above, the court finds that the plaintiff failed to carry its burden of proof that it has a proper purpose for its demand. Judgment is entered in favor of the defendants. IT IS SO ORDERED.

that THQ has somehow engaged in mismanagement by failing to maintain a separate general ledger for the joint venture are likewise misplaced. THQ's accounting system gives THQ the ability to extract joint venture-specific data as needed.