

INSIGHTS

Delaware Supreme Court Rules That Privileged Documents Must Be Produced To Shareholders Investigating Corporate Misconduct

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The Delaware Supreme Court recently held that, in certain circumstances, shareholders may be able to obtain access to privileged, internal documents in order to investigate potential breaches of fiduciary duty. In *Wal-Mart Stores, Inc. v. Indiana Electrical Workers Pension Trust Fund IBEW*, No. 614, 2013, 2014 WL 3638848 (Del. July 23, 2014), the Court, sitting *en banc*, unanimously ruled that a pension fund that owned Wal-Mart stock was entitled to receive privileged documents relating to Wal-Mart's internal investigation of Foreign Corrupt Practices Act violations at a Mexican subsidiary because the documents were "necessary and essential" to determine whether Wal-Mart's board had breached its fiduciary duties. This decision is significant not only because it is the first time that Delaware courts have adopted the "fiduciary exception" to the attorney-client privilege articulated by the United States Court of Appeals for the Fifth Circuit in *Garner v. Wolfenbarger* (the "*Garner* exception"), but also because it extended the *Garner* exception beyond plenary shareholder suits to shareholder books and records demands under Section 220 of the Delaware Corporations Law.

Background

This action arose out of Wal-Mart's alleged mishandling of an investigation into bribery by executives at Wal-Mart de Mexico, S.A. de C.V. ("WalMex"). In September 2005, an employee of WalMex informed Maritza I. Munich, general counsel of Wal-Mart International, about "'irregularities' authorized by 'the highest levels' at WalMex." *Id.* at *1. Munich hired an international law firm to develop an investigation plan but Wal-Mart executives rejected that initial proposal for a "thorough investigation" in favor of a short, two-week "preliminary inquiry." *Id.* at *2. When the brief investigation concluded that "[t]here is reasonable suspicion to believe that Mexican and USA laws have been violated," senior executives at Wal-Mart criticized the investigators for being "overly aggressive" and the CEO himself ordered the investigation to be taken in-house and transferred to one of the early targets of the investigation, WalMex's General Counsel. *Id.* Munich criticized the decision to transfer the investigation to one of the officials suspected of wrongdoing and, around the same time, Munich resigned from the company. The WalMex legal team now tasked with leading the probe quickly wrapped up the inquiry "with little additional investigation" and cleared all WalMex executives of wrongdoing. *Id.*

The bribery allegations and subsequent investigation eventually came to light in a series of articles that ran in *The New York Times* in April 2012. Two months later, the Indiana Electrical Workers Pension Trust Fund IBEW ("IBEW") sent a demand letter to Wal-Mart requesting inspection of various documents relating to the allegations and investigation in order to

determine (1) whether there was any mismanagement in connection with the allegations, (2) whether there was a possible breach of fiduciary duty, and (3) "whether a pre-suit demand on the board would be futile as part of a derivative suit." *Id.* Wal-Mart promptly provided a set of heavily redacted and non-privileged material.

The Section 220 Lawsuit

In August 2012, IBEW filed a lawsuit against Wal-Mart in the Delaware Court of Chancery seeking additional disclosures pursuant to Section 220 of the Delaware Corporations Law, which provides shareholders with the right to inspect various corporate books and records and bring a lawsuit in the Chancery Court if they believe the company did not adequately respond to the demand notice. *See* Del. Gen. Corp. L. § 220. The Chancery Court (Strine, Ch.) eventually ordered Wal-Mart to produce a wide-range of documents, collected from a dozen custodians, all relating to the company's anti-bribery compliance procedures, the specific WalMex corruption allegations, and the investigation that followed. *Wal-Mart*, 2014 WL 3638848, at *4.

Among the documents that the Chancery Court ordered Wal-Mart to produce were privileged documents that are typically protected from discovery. The Chancery Court justified the disclosure of privileged items by invoking the *Garner* exception, which was first articulated by the U.S. Court of Appeals for the Fifth Circuit nearly forty-five years ago in *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970). In that case, the Fifth Circuit recognized an exception to the attorney-client privilege when shareholders sue fiduciaries for acting "inimically" to shareholder interests. *Id.* at 1103-04. This so-called "fiduciary exception" to the attorney-client privilege allows plaintiff shareholders to review privileged corporate files if they can demonstrate "good cause" for disclosure of the protected documents. *Wal-Mart*, 2014 WL 3638848, at *13. The Chancery Court found that the plaintiffs had shown good cause to examine the records – they had enough "skin in the game," as the Chancery Court judge described it – and ordered Wal-Mart to produce the documents.

The Delaware Supreme Court's Ruling

Wal-Mart appealed to the Delaware Supreme Court, arguing that the discovery order was both substantively too broad and should not have included privileged documents. On the question of scope, Wal-Mart unsuccessfully argued that officer-level documents that were never presented to the board should not have been included in the discovery order because they had no relevance to whether a board demand would be futile. The Court rejected Wal-Mart's arguments on this point, instead allowing the broad discovery request because the plaintiffs' stated goal was not simply to determine whether a demand would be futile, but to understand whether there was any underlying misconduct. *Id.* at *6-7. As the Court explained, in order to discover the extent of the wrongdoing and any shortcomings in Wal-Mart's compliance program, the plaintiffs needed access to documents from various levels of the Wal-Mart hierarchy. *Id.*

On the matter of privilege, Wal-Mart argued that the *Garner* exception had never been formally adopted by Delaware courts and that, in any event, the exception should not apply to a "summary" Section 220 proceeding. *Id.* at *9. The judges of the Delaware Supreme Court unanimously rejected Wal-Mart's plea to reverse the Chancery Court's order. Instead, the Court expressly adopted the *Garner* exception as a valid exception to the attorney-client privilege under Delaware law, adding that it can be used in "plenary stockholder/corporation proceedings" as well as more focused Section 220 suits. *Id.* at *11. In reaching this conclusion, the Court cited several prior decisions by the Delaware Supreme Court and Delaware Court of

Chancery where *Garner* was cited with approval. *Id.* at *10-11. The Court also endorsed the merits of the *Garner* exception, noting that it "achieves a proper balance between legitimate competing interests" of shareholders who have the right to inspect documents for wrongdoing and corporate officers who need the attorney-client privilege in order to facilitate open communication with legal counsel. *Id.* at *11. In addition to formally recognizing the exception, the Court favorably cited the *Garner* factors that were enumerated in the Fifth Circuit's decision and have since been used by courts to determine whether a plaintiff has satisfied his burden of demonstrating "good cause." *Id.* at *10 n.32, 13, 14.

Applying the *Garner* exception and *Garner* factors to the particular facts of the IBEW action, the Delaware Supreme Court held that the shareholders had satisfied their burden of demonstrating "good cause" to inspect responsive privileged documents. The Court noted that the plaintiffs satisfied their burden by demonstrating that: (1) the privileged documents in question were "necessary and essential to IBEW's proper purposes," (2) plaintiffs had a colorable claim, (3) the information contained in the privileged documents was not available in any other, non-privileged source, (4) the request for documents was particularized such that the plaintiffs were not "blindly fishing," (5) disclosure of the documents "would not risk the revelation of trade secrets," (6) "the allegations at issue implicate criminal conduct . . .," and (7) the plaintiffs are legitimate shareholders. *Id.* at *13. The Court further held that the documents were not protected by the attorney work-product doctrine for largely the same reasons that they were not protected by the attorney-client privilege. *Id.* at *13-14.

Takeaways

The Delaware Supreme Court's *Wal-Mart* decision is noteworthy in large part because the Court formally recognized the so-called *Garner* exception as the law of Delaware. The decision also is noteworthy because it clarifies that the application of the *Garner* exception is not limited to plenary shareholder actions challenging corporate conduct, but also extends to Section 220 actions – essentially, the pre-filing investigative phase of shareholder litigations. For corporations and their executives, the lesson to be learned is stark: the involvement of legal counsel in internal investigations and other internal matters is not a guarantee of secrecy. Accordingly, corporations and their executives should be mindful that, even if legal counsel is involved, sensitive internal communications may someday end up in the hands of shareholders seeking to ferret out corporate misconduct or oversights.