

# Client Alert

Business Litigation Practice Group

August 5, 2014

## Delaware Supreme Court Extends Shareholder Books and Records Inspection Rights to Privileged Internal Investigation Documents

A recent decision of the Delaware Supreme Court approved granting shareholders the right to inspect privileged and confidential internal investigation materials upon showing “good cause.”<sup>1</sup> Directors and general counsels should be aware of the *Wal-Mart* decision because it reflects continued heightened scrutiny of the board’s role in compliance oversight and subjects sensitive internal investigation documents protected by “the oldest privilege recognized by Anglo-American jurisprudence” to inspection by shareholders seeking to substantiate claims that directors breached their fiduciary duties. The *Wal-Mart* decision could also trigger an increase in shareholder requests to inspect corporate books and records related to potential regulatory/legal violations.

### The Delaware Supreme Court’s Holding

*Wal-Mart* addressed a books and records inspection demand under Delaware law by shareholder Electrical Workers Pension Trust Fund IBEW (“IBEW”) seeking to inspect documents pertaining to an alleged bribery scheme involving a Mexican subsidiary of Wal-Mart between 2002 and 2005. The inspection demand followed an April 2012 *New York Times* article reporting that Wal-Mart executives disregarded an initial investigation revealing significant problems, instead turning the investigation over to the general counsel of the Mexican subsidiary, who was himself implicated in the initial review. According to IBEW’s demand letter, its purpose for the inspection demand was to investigate possible mismanagement and/or breaches of fiduciary duty in connection with the alleged bribery scheme and the Company’s response, and to determine whether pre-suit demand on the Board would be futile as part of a derivative lawsuit to recover damages on behalf of Wal-Mart. Wal-Mart produced hundreds of thousands of pages of documents in response to the demand, but redacted or otherwise declined to provide documents that it determined were not “necessary and essential” to the purposes of IBEW’s demand or that were protected by the attorney-client privilege and/or the work product doctrine.

IBEW brought an action pursuant to Title 8, Section 220 of the Delaware Code to enforce shareholder inspection rights with respect to the withheld documents. The Court of Chancery ordered Wal-Mart to produce certain

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internal documents concerning what its directors and officers knew about the bribery allegations, including officer-level documents never provided to the board and documents protected by the attorney-client privilege and work product doctrine. Wal-Mart appealed, arguing that the scope of the production ordered by the Court of Chancery was not “necessary and essential” to the proper purposes of IBEW’s demand, the standard for discovery in Section 220 actions.

The Delaware Supreme Court rejected Wal-Mart’s arguments and affirmed the Court of Chancery’s grant of inspection rights. In doing so, the Supreme Court ruled that officer-level documents never before presented to the Board were “necessary and essential” to IBEW’s demand, because the stated purposes of the demand were broader than simply determining whether a demand on the Board would be futile, and included an investigation of the underlying bribery scandal and how the ensuing investigation by the Company was handled. The Supreme Court affirmed the ruling that the officer-level documents were “necessary and essential to determining whether and to what extent mismanagement occurred and what information was transmitted to Wal-Mart’s directors and officers,” because key officers were involved in the Company’s investigation of the bribery allegations.

More critically, the Delaware Supreme Court adopted an exception to the attorney-client privilege—the so-called “*Garner* doctrine.” The *Garner* doctrine is named for a 1970 decision of the Fifth Circuit Court of Appeals, which recognized an exception to the attorney-client privilege, allowing shareholders alleging breach of fiduciary duty claims against corporate directors and officers to invade a corporation’s attorney-client privilege upon a showing of “good cause.”<sup>2</sup> The Delaware Supreme Court’s adoption of *Garner* in *Wal-Mart* means that the attorney-client privilege is now subject to an exception in Delaware where shareholders purporting to act for the benefit of the company can show a need for otherwise privileged information to substantiate a claim that directors or officers breached their fiduciary duties. The Supreme Court did observe, however, that the exception is “narrow, exacting, and intended to be very difficult to satisfy.”

In upholding the lower court’s application of the *Garner* doctrine in *Wal-Mart*, the Delaware Supreme Court found that the privileged communications surrounding the internal investigations were “necessary and essential” to IBEW’s demand because IBEW sought information concerning the Board’s handling of the alleged bribery scandal, whether an internal cover-up of the scandal occurred, and what information was shared with the Board regarding the scandal. IBEW demonstrated “good cause” for the disclosure of privileged documents by Wal-Mart because IBEW had shown an “obviously colorable” claim for breach of fiduciary duty by certain officers and perhaps the board, and the information needed for IBEW to assert that claim was not currently available from other sources. As such, the Supreme Court held that “the record supports the Court of Chancery’s conclusion that the documentary information sought in the Demand should be produced by Wal-Mart pursuant to the *Garner* fiduciary exception to the attorney-client privilege.”

## Implications of the Decision

While recognition of the *Garner* exception to the attorney-client privilege was perhaps not surprising – several Delaware lower court decisions had followed *Garner* – the decision to apply *Garner* in the context of a pre-litigation books and records inspection demand caught many observers of Delaware law off-guard. Some commentators had predicted that the Delaware high court would only follow *Garner* in the discovery phase of litigation after a court had found that the plaintiff’s allegations of wrongdoing were sufficient to survive a motion to dismiss. Instead, the Supreme Court embraced application of *Garner* to pre-litigation shareholder books and records inspection requests where a shareholder only needs to claim he is investigating certain specified potential “wrongdoing.”

The endorsement of *Garner* in the books and records inspection context, as well as the Delaware Supreme Court's approval of far-reaching inspection requests (which sought documents generated over a seven-year period), could subject Delaware corporations to an increase in both costly inspection requests as well as derivative litigation against boards. A majority of derivative suits claiming breach of fiduciary duty by corporate boards are dismissed prior to any discovery under Delaware's strict pleading requirements governing attempts to establish that pre-suit demand on the board should be excused as futile. With the potentially broader access to internal corporate documents portended by *Wal-Mart*, shareholder plaintiffs may be able to plead demand futility with greater particularity, and could both bring a greater number of derivative suits and see more such suits survive a motion to dismiss. The extent to which shareholder plaintiffs will be able to successfully rely on *Wal-Mart* to obtain privileged documents will depend on whether courts honor *Wal-Mart*'s admonition that the *Garner* exception should be construed as "narrow, exacting, and . . . very difficult to satisfy."

There is reason to believe that *Wal-Mart*'s holding may be limited to the particular and compelling facts of that case. First, *Wal-Mart* arose from specific allegations of criminal and other illegal conduct, which *Garner* held was a factor courts should consider in deciding whether to require the disclosure of privileged documents. Second, the Delaware Supreme Court noted that, under *Garner*'s test, courts should consider whether shareholders have stated an "obviously colorable" claim, as opposed to "blindly fishing" for information. The shareholders in *Wal-Mart* were in the unique position of being able to rely on *The New York Times* article describing in great detail the alleged bribery scheme and the Company's allegedly inadequate response. In addition, *Wal-Mart*'s own public statements suggested real concerns about the legality of its conduct in Mexico. In most cases, shareholders will not have that luxury. In cases involving allegations of less weight and substantiation, courts may not be as inclined to order the production of privileged materials or permit broad inspection rights.

Nevertheless, *Wal-Mart* serves as a sobering reminder that privileges are not absolute and that the board's role in overseeing corporate compliance will continue to come under greater scrutiny by shareholders and the courts. Directors, officers, and their counsel should bear in mind the risk that even privileged communications and attorney work product related to internal investigations of potential legal violations may one day have to be disclosed to shareholders. Accordingly, such materials should be prepared with that risk in mind, especially after *Wal-Mart*. In addition, following *Wal-Mart*, boards should expect more frequent shareholder litigation claiming that the board breached fiduciary duties by failing to provide appropriate oversight of legal compliance where violations of law occur in some corner of the company. To address the new reality of greater board accountability for corporate legal compliance, corporate boards should engage in periodic assessments of their companies' internal control structure over legal compliance to assure that controls are adequately designed and operate effectively to provide management and the board reasonable assurance of full legal compliance.

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<sup>1</sup> See *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Trust Fund IBEW*, No. 614, 2013 (Del. Jul. 23, 2014).

<sup>2</sup> *Garner v. Wolfenbarger*, 439 F.2d 1093 (5th Cir. 1970).