

Shareholder Inspection Demand to Obtain Internal Investigation Documents “Not Essential” To Identified Proper Purpose

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Aggrieved Stockholders often seek production of the books and records of a corporation when challenging corporate decisions in shareholder derivative actions, minority oppression cases, and related contexts. Inspection demands are a time tested strategy to put pressure on the corporation or majority shareholders to dissuade them from taking allegedly unfair or unauthorized actions or as a prelude to litigation. One of the most important safeguards for the corporation is the requirement that a shareholder demand articulate a proper purpose for inspection of the corporation’s books and Records. Frequently, the determination of what is a proper purpose and the scope of the production to meet the proper purpose is disputed.

The Espinosa Case

The Delaware Supreme Court recently addressed the question of the scope of production in a very instructive opinion: ***Espinoza v. Hewlett-Packard Co.*, --- A.3d ----, 2011 WL 5838882 (Del. Nov. 21, 2011) (J. Jacobs)**. The *Espinosa* case involved the now infamous circumstances surrounding the departure of former Hewlett-Packard (“HP”) CEO and Chairman Mark Hurd.

HP engaged independent counsel to investigate sexual harassment allegations a contractor levied against Hurd. The law firm issued a written report to the HP board which detailed their findings. Shortly after submission of the report, Hurd settled with the contractor. HP then announced Hurd’s departure from HP, and announced that Hurd had violated HP’s standards of business conduct, without confirmation that Hurd engaged in sexual harassment. HP approved a separation agreement with a package of severance benefits approximating \$30 million.

Various shareholders filed derivative actions related to Hurd’s resignation and the severance package. One shareholder, Ernesto Espinoza, demanded all books and records relating to Hurd’s resignation under 8 *Del. C.* § 220. While disputing Espinoza’s entitlement to these records, HP nonetheless provided most of the specific documents requested. HP declined to produce voluntarily the law firm’s investigation report on the basis of the attorney-client privilege and work product immunity doctrine. After HP refused his renewed demand for the investigation materials, Espinoza filed a Section 220 action to compel production.

The Court of Chancery rejected Espinoza’s demand, because he had not established any special need for the investigation report sufficient to overcome either the attorney-client

privilege or work product objections. The Court of Chancery's reliance on the attorney-client privilege and work product doctrine, sidestepped the question whether Espinoza had a right to inspect the investigation materials in the first place. Espinoza appealed.

On appeal, the Delaware Supreme Court, affirmed the Chancery Court, but on different grounds. Espinoza had articulated a proper purpose: to investigate possible wrongdoing and mismanagement. The Supreme Court, however, found that Espinoza carried the burden but failed to show that the corporate records he sought were essential to the stated purpose for inspection. Corporate books and records are "essential" if they address the core issues underlying the proper purpose and are otherwise not available from other sources. Espinoza understandably claimed the investigation report was essential to his purpose of investigating why HP paid millions in severance benefits rather than termination for cause. He argued the investigation report provided HP's Board with an analysis of potential disciplinary options or formed basis for board discussion of disciplinary options. Understanding these options and the Board's evaluation of them were central to his shareholder complaint.

The Delaware Supreme Court was not moved. The Court reasoned that Espinoza failed to satisfy his burden of proving the investigation report itself is essential to his purpose. HP represented that the report was bereft of discussion of termination for cause options. Based on that representation, the Court of Chancery found that the investigation report did not address the "for cause" issue and Espinoza did not directly contest that finding on appeal. Consequently, the record failed to disclose that the report played any significant role in the board's discussion of any "for cause" termination or other alternatives. HP did not engage the law firm to perform its investigation and write a report to advise the Board on its termination versus severance decision. The board held numerous meetings between the end of the investigation and the law firm's submission of its report and Hurd's departure, without further involvement of the law firm.

Moreover, HP disclosed the essential aspects of the investigation to Espinoza. HP furnished substantial documents regarding the circumstances surrounding Hurd's resignation. These records included the specific allegations prompting the investigation, documents summarizing the misconduct alleged, as well as the key findings of the investigation report. The Supreme Court found it unnecessary to decide whether the specific investigation documents were shielded by the attorney-client privilege or work product immunity doctrine. The Court's conclusion that the investigation report went beyond the scope of the proper purpose Plaintiff articulated under Section 220, the privilege issues were essentially moot.

Espinoza Is Significant—Both For What It Does and Does Not Say

The usual battleground between shareholders and corporations is whether there is a proper purpose for the demand. *Espinoza* reinforces that there is wide latitude for creativity and advocacy in shaping responses to shareholder inspection demands, not only as to threshold appropriateness, but also as to what items are relevant and necessary to produce. *Espinoza* means that the scope of documents required to be produced in

response to a Section 220 demand is bounded by the purpose the shareholder states to justify the demand. In considering potential responses to inspection, corporations should consider the “essentiality” requirement, and how it may narrow what a company must actually produce in response to a proper demand.

In an era of internal investigations, this case leaves open important questions of the applicability of the attorney-client privilege and work product immunity doctrine in the context of shareholder inspection demands. While the Supreme Court did not specifically undermine the Chancery Court’s reliance on these protections, the Court’s lack of direction on the specifics of them and reliance on alternative decisional grounds is noteworthy. With the potential for disclosure of internal investigations in derivative actions, corporations and their boards must assess this risk and take special care to define the scope of investigations very clearly and take all precautions to protect privileged communications.

It is also interesting that the Delaware Supreme Court placed great reliance on lawyers’ representations to the courts on what the documents did and did not contain. This suggests that the standard is not discovery-based (reasonably likely to lead to discovery of admissible evidence). No competent counsel would accept assurances in discovery that key documents do not contain discussion of a topic closely associated with the apparent subject matter of the document. Yet, the Court of Chancery relied on the representations of HP’s counsel that the investigation report did not discuss whether Hurd could be terminated for cause. This finding provided critical support for the Supreme Court’s alternative holding that the report was not essential to the concededly proper purpose of the demand. The Supreme Court did observe that the Court of Chancery could have reviewed the investigation materials *in camera*, to resolve any disputes over the contents of the requested documents. While it did not find that process necessary, the Supreme Court did note that an *in camera* inspection by the trial court may be appropriate.

Glenn Davis’ practice area expertise includes Antitrust Litigation and counseling, Business Litigation and Securities Litigation. He has successfully handled sophisticated antitrust litigation, class action and corporate business matters for clients in agribusiness, construction equipment, franchising, healthcare, manufacturing, pharmaceuticals, product distribution, securities, financial services and other industries. In addition to numerous jury and bench trials in federal and state courts, he has litigated in hearings, tribunals and investigative proceedings before the Federal Trade Commission, the Securities Exchange Commission and other industry arbitration forums. He has been recognized as a Missouri Super Lawyer annually since 2005 and named one of the top 50 lawyers in St. Louis in 2011. He is also named in *Best Lawyers* for antitrust law and litigation and several other categories. He is also a Charter Fellow in the Litigation Counsel of America, a leading trial lawyers’ honorary society. Mr. Davis can be reached by phone at 314-615-6217 or via email at glenn.davis@GallopLaw.com.

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