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Fiduciary Exception to Privilege in Books and Records Case

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The attorney-client privilege is the oldest privilege recognized by Anglo-American jurisprudence, and its origins can be traced to ancient Rome. It is critical to encouraging frank and full communications between clients and their attorneys, thereby promoting the public interest in legal compliance and the proper administration of justice. The attorney-client privilege is, however, an exception to the fundamental principle that the public has a right to every person's evidence and the fundamental responsibility of every person to give testimony. Thus, although thought to be sacrosanct, the attorney-client privilege is confined, and the courts have struggled to define its limits.

Certain exceptions are now ingrained generally in the law, such as those applying to communications in contemplation of a crime or fraud and communications to a joint attorney. Another, the fiduciary exception, established in the seminal case of *Garner v. Wolfinbarger*, 430 F.2d 1093. 1103 (5th Cir. 1970), which limits application of the attorney-client privilege "where the corporation is in suit against its stockholders on charges of acting inimically to stockholder interests," is widely accepted, but has been the subject of controversy as the courts have expanded and applied the exception in an increasing variety of circumstances.

Last month, the Delaware Supreme Court considered the Garner exception, expressly adopting it for the first time as applicable in both plenary actions and Section 220 books and records proceedings. *Wal-Mart Stores v. Indiana Electrical Workers Pension Trust Fund IBEW,* 2014 WL 3638848 (Del. Supr. July 23, 2014). *Wal-Mart* was an appeal from a decision of then Chancellor Leo E. Strine ordering broad discovery in a Section 220 proceeding[1] brought by a shareholder of Wal-Mart Stores, the Indiana Electrical Workers Pension Trust Fund IBEW (IBEW), seeking discovery to investigate bribery and cover-up allegations and to support a claim of demand futility.[2] *Wal-Mart* is an important reminder to corporate managers and directors of the breadth of discovery available under Section 220 and of the potential for shareholders to obtain sensitive documents thought to be covered by the attorney-client privilege.

The Garner Exception

In *Garner,* stockholders brought both class and derivative securities fraud claims against First American Life Insurance Company of Alabama (FAL), its officers and directors. During discovery, the former general counsel declined to answer questions or to produce certain documents concerning advice he gave regarding the issuance and sale of FAL stock, asserting the corporation's attorney-client privilege. In affirming a district court decision holding that a corporation and its management could not invoke the attorney-client privilege against its shareholders, the U.S. Court of Appeals for the Fifth Circuit established a balancing test based on one of the four conditions necessary to establish the privilege, i.e., "the injury that would inure to the relation by the disclosure of the communications must be greater than the benefit thereby gained for the correct disposal of litigation." *Garner,* 430 F.2d at 1100-01, citing 8 Wigmore, Evidence §2285.

Garner held that "where the corporation is in suit against its stockholders on charges of acting inimically to stockholder interests, protection of those interests as well as those of the corporation and of the public require that the availability of the privilege be subject to the right of the stockholders to show cause why it should not be invoked in the particular instance." Id. at 1103-04. Thus, while management is entitled to a presumption that the privilege applies, the shareholders may rebut the presumption by demonstrating "good cause" why it should not apply in a particular situation.

Garner specifically noted the decision was not dependent on the derivative claim, which was the subject of a motion to dismiss. Unconcerned that a damages award might go to individuals rather than to the corporation, the court's analysis instead focused on the relationship between the parties and the notion that management does not manage for itself but rather for the benefit of the shareholders. *Garner* provided nine indicia which could be used to determine the presence or absence of "good cause" [3] and then, without further analysis, the case was remanded for further proceedings.

Over the succeeding 40 years, *Garner* has spawned a large body of law debating the scope and applicability of the fiduciary exception. *Garner* itself raised a number of issues without resolving them. Observing that "[c]onceptualistic phrases describing the corporation as an entity separate from its stockholders are not useful tools of analysis," the court noted "there may be reasonable differences over the manner of characterizing in legal terminology the duties of management, and over the extent to which corporate management is less of a fiduciary than the common law trustee" and "[t]here may be many situations in which the corporate entity or its management, or both, have interests adverse to those of some or all stockholders." Id. at 1101. These noted difficulties, and many others, have created controversy over the scope of the exception and its application in a wide variety of situations.

Should the exception be limited to derivative actions where the corporation's interests, and not individual shareholder interests, are at stake? Should it be applicable generally to shareholder actions and, if so, should it be limited to class actions or may individual shareholders assert the Garner exception? Should the rule be applicable more generally to all cases where there is some "mutuality of interest" or "quasi-fiduciary" relationship, rather than a strict fiduciary relationship, or should it be more limited?

The Wal-Mart Decision

Wal-Mart arose from a New York Times article, published in April 2012, which described a scheme of illegal bribery payments to Mexican officials at the direction of the CEO of Wal-Mex, a subsidiary of Wal-Mart, and Wal-Mart's deficient responses to it. The general counsel of Wal-Mart International, Maritza

Munich, hired outside counsel to develop an independent investigative plan, which was allegedly rejected by senior Wal-Mart leadership in the United States. A brief “preliminary inquiry” took its place and allegedly found evidence corroborating the allegations, but was criticized as “overly aggressive” by that same management.

The investigation was turned over to “one of its earliest targets”, the general counsel of Wal-Mex, over the objections of Munich, who resigned, complaining that “[t]he wisdom of assigning any investigative role to management of the business unit being investigated escapes me.” 2014 WL 3638848 at *2. The Wal-Mex general counsel “wrapped up the case in a few weeks, with little additional investigation,” concluding that “[t]here is no evidence or clear indication of bribes paid to Mexican government authorities with the purpose of wrongfully securing any licenses or permits.” Id.

Shortly after the article was published, Wal-Mart received a demand from IBEW for inspection of broad categories of documents. IBEW’s stated purpose was to investigate mismanagement in connection with the Wal-Mex allegations, breaches of fiduciary duty by Wal-Mart or Wal-Mex executives in connection with the bribery allegations, and whether demand on the board was excused in connection with a derivative action. Although Wal-Mart made certain records available to IBEW, it declined to provide others on various grounds, including the attorney-client privilege and work-product doctrine.

IBEW filed a Section 220 complaint in the Chancery Court. Section 220 provides shareholders of a Delaware corporation with the right to inspect those books and records of the corporation “necessary and essential” to a proper purpose, defined as a purpose “reasonably related” to the person’s interest as a stockholder. *Saito v. McKesson HBOC,* 806 A.2d 113 (Del. 2002). The Chancery Court is vested with exclusive jurisdiction to enforce those rights in summary proceedings. Applying this standard, then Chancellor Strine ordered broad discovery, including the production of privileged and work product documents, citing *Garner.*

On appeal, Wal-Mart claimed that the discovery order went beyond the proper scope of a Section 220 proceeding, arguing that Delaware had never adopted the Garner exception, and even if it was generally applicable, it should not apply in a Section 220 proceeding, where discovery should be narrowly circumscribed, and it did not cover work-product documents.[4]

The Delaware Supreme Court affirmed Strine’s order, concluding that the broad discovery ordered was an appropriate exercise of his discretion. Addressing Wal-Mart’s argument that the scope of relief given by the Chancery Court was “unprecedented” and not circumscribed with the “rifled precision” required under Section 220, *Saito v McKesson HBOC,* 806 A.2d 113 (Del. 2002), *Wal-Mart* clarified that the term “rifled precision” is a qualitative term, not “a quantitative limitation” on a stockholder’s right to obtain *“all* documents that are necessary and essential to a proper purpose.” 2014 WL 3638848 *16 (Emphasis in original).

Then, in a precedent-setting determination, Wal-Mart held the Garner exception should be applied “in plenary stockholder/corporation proceedings” and in Section 220 proceedings, noting it had “tacitly endorsed” the exception previously and the Court of Chancery had expressly adopted it and applied it in Section 220 proceedings.[5] Wal-Mart further held that the “necessary and essential” inquiry, required by Section 220, must precede any privilege inquiry because “it is dispositive of the threshold question” of the scope of document production.

Applying these holdings, *Wal-Mart* found Strine had properly applied the Garner exception, first considering whether the documents were “necessary and essential to [IBEW’s] proper purposes,” including “the handling of the Wal-Mex investigation, whether a cover-up took place, and what details were shared with the Wal-Mart Board," id. at *11, and then finding "good cause" to order production of the documents.

The Supreme Court pointed to the chancellor's findings that a "colorable claim existed" based on Wal-Mart's own public statements suggesting "there was some real concerns about what was going on in Mexico and whether it was legal" and that the information was not available from other, non-privileged sources because "where there is a colorable basis that part of the wrongdoing was in the way the investigation itself was conducted... it's very difficult to find those documents by other means." Id. at *12. The Supreme Court also noted that the Chancery Court had determined the request was not "a broad fishing expedition" and did not seek documents concerning the litigation itself, such as "how to defend against what the plaintiffs are doing." [6]

Addressing Wal-Mart's argument that *Garner* should not apply to documents that are attorney's work product, the Supreme Court agreed that *Garner* does not create an exception for work product documents.[7] Rather, discovery of those documents is governed by Chancery Court Rule 26(b)(3), providing party access to such documents "upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable?? without undue hardship to obtain the substantial equivalent of the materials by other means." Id. at *13. However, the Supreme Court found the "good cause" requirements of *Garner* overlap with Rule 26(b)(3)'s requirements, explaining it had previously used the Garner good cause factors to analyze compliance with Rule 26(b)(3). Garner at *14, quoting *Zirn,* 621 A.2d at 782. *Wal-Mart* found the Chancery Court had properly considered the overlapping "good cause" factors, but had ruled, "properly and solely," on the basis of Rule 26(b)(3).

Analysis

Beyond its application of *Garner* to a Section 220 books and records action and its comment on the broad scope of discovery allowed under that section, the Supreme Court in *Wal-Mart* applied the Garner exception in a matter where shareholder interests are plainly impacted and director fiduciary duties are at issue. Plaintiffs will likely try to expand its use into other areas, as they have in other jurisdictions, and *Wal-Mart* gave no indication as to the limits on its use, holding only that the exception should be used in "stockholder/corporation" actions.

The U.S. Supreme Court has not addressed the Garner fiduciary exception directly but has acknowledged its wide use in the federal *courts.*[8] *United States v Jicarilla Apache Nation,* 131 S. Ct. 2313 (2011). It is doubtful, however, that when presented with an appropriate case, the U.S. Supreme Court would endorse the balancing test of *Garner,* since it has emphasized the need for predictability in its attorney-client decisions.[9] Meanwhile, perhaps future Delaware decisions will provide guidance and more certainty with respect to the contours of the Gamer exception.

Endnotes:

1 Del. Code Ann. Tit. 8, Section 220 (2014).

2 *Indiana Electrical Workers Pension Trust Fund IBEW v. Wal-Mart Stores*, 2013 WL 5636296 (Del. Ch.).

3 "There are many indicia that may contribute to a decision of presence or absence of good cause, among them the number of shareholders and the percentage of stock they represent; the bona fides of the shareholders; the nature of the shareholders' claim and whether it is obviously colorable; the apparent necessity or desirability of the shareholders having the information and the availability of it from other sources; whether, if the shareholders' claim is of wrongful action by the corporation, it is of action criminal, or illegal but not criminal, or of doubtful legality; whether the communication related to past or to prospective actions; whether the communication is of advice concerning

the litigation itself; the extent to which the communication is identified versus the extent to which the shareholders are blindly fishing; the risk of revelation of trade secrets or other information in whose confidentiality the corporation has an interest for independent reasons." *Garner.* 430 F.2d at 1104.

[4] There were several other issues raised, including an interesting one about documents IBEW had received anonymously from a whistleblower who Wal-Mart claimed was an ex-employee who had stolen the documents. The Chancery Court, using a conversion theory, granted Wal-Mart's motion to strike use of most of the whistleblower documents, holding the documents remained privileged and ordering their return to Wal-Mart. The exception was for those documents already made public, including by The New York Times, Congress, or Wal-Mart's own public filings, as to which documents the court found Wal-Mart had lost the privilege, despite the dissemination of some of the documents without Wal-Mart's consent. Strine also noted that "it might be a momentary return" because IBEW was free to argue that Wal-Mart should have produced the documents pursuant to the document demand. The Supreme Court found that the Chancery Court had "properly discharged its equitable discretion in crafting a remedy for Wal-Mart."

[5] See *Zirn v. VLI Corp.,* 621 A.2d 773, 781-82 (Del. 1993); *Espinoza v. Hewlett-Packard Co.,* 32 A.3d 365, 374 (Del. 2011); *Grimes v. DSC Communications Corp.,* 724 A.2d 561, 568-69 (Del. Ch. 1998); *Khanna v. Covad Communications Group,* 2004 WL 187274, at *7 (Del. Ch. Jan. 23, 2004); and *Saito v. McKesson HBOC,* 2002 WL 31657622, at *12-13 (Del-Ch. Nov. 13,2002).

[6] The Supreme Court noted that Strine had taken steps to maintain the "confidentiality" of Wal-Mart's privileged documents (one of *Garner's* good cause factors). In particular, Strine's order said "such production shall not prejudice Defendant's ability to assert privilege and/or work-product protection vis-a-vis any third party." 2013 WL 5636296 *3 (Del. Ch.) This raises interesting waiver issues beyond the scope of this article.

[7] This clarification, following *In re International Systems & Controls Corp. Securities Lit.,* 643 F.2d 1235 (5th Cir. 1982), declining to apply the fiduciary exception to work product documents (which by definition are created in an adverse relationship), was helpful because the Chancery Court had previously issued inconsistent decisions on this point.

[8] Although the Second Circuit has not explicitly addressed and accepted *Garner* and the fiduciary exception, it appears to "assume that there is a fiduciary exception." *RMED International v. Sloan's Supermarkets,* 2003 WL 41996 at *4, FN 12 (S.D.N.Y. Jan. 6, 2003) (citing *In re Dow Corning Corp.,* 261 F.3d 280, 286 (2d Cir. 2001)). After citing Southern District court decisions adopting or applying *Garner,* then District Judge Peter K. Leisure stated that he was "confident that the Garner rationale is alive and well in this Circuit." RMED, at *4.

[9] See, e.g., *Upjohn Co. v United States, 401 U.S. 974* (1971) ("[a]n uncertain privilege...is little better than no privilege at all."); *Swindler & Berlin v. United States,* 524 U.S. 399, 409 (1988) (holding attorney-client privilege survives death of client and rejecting a balancing test: "[b]alancing ex post the importance of the information against client interests... introduced substantial uncertainty into the privilege's application. For just that reason, we have rejected use of a balancing test in defining the contours of the privilege.")