

White Collar Crime - USA

Delaware Supreme Court adopts fiduciary exception to attorney-client privilege

Contributed by [Hogan Lovells US LLP](#)

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Introduction

The Delaware Supreme Court recently issued a decision that has the potential to affect how corporations across the United States conduct investigations and communicate with their attorneys. The decision, *Wal-Mart Stores, Inc v Indiana Electrical Workers Pension Trust Fund IBEW*,⁽¹⁾ adopted the fiduciary exception to attorney-client privilege, which allows shareholders access to a company's privileged communications when there is "good cause" to believe that management may have breached a fiduciary duty to the shareholders.⁽²⁾

Wal-Mart Stores, Inc may have especially far-reaching consequences because it was decided by the highest court in Delaware, a state in which more than half of all publicly traded companies are domiciled and may be subject to suit.⁽³⁾ Any of these corporations is now at risk of having to disclose an internal investigation report, emails or other documents likely presumed to be protected from disclosure. Further complicating matters, a minority of jurisdictions – including California – do not recognise the fiduciary exception to attorney-client privilege.⁽⁴⁾ Thus, a company sued in California may be able to withhold certain privileged documents, while a company sued in Delaware may not.

Wal-Mart Stores, Inc casts a cloud of unpredictability over the question of when attorney-client communications might later be accessed by shareholders, and thus calls for close study from attorneys who represent corporations. Under *Wal-Mart Stores, Inc*, any communications regarding an investigation of alleged criminal conduct that do not contain trade secrets may be especially vulnerable to disclosure, particularly when shareholders can identify specific documents.

Facts

In April 2012 *The New York Times* reported allegations of illegal bribery by WalMex, a Wal-Mart subsidiary, as well as a deficient investigation by Wal-Mart.⁽⁵⁾ The article reported that WalMex had engaged in a widespread scheme of illegal bribery payments to Mexican government officials between 2002 and 2005. It further reported that Wal-Mart executives were aware of the conduct by at least September 21 2005, when a WalMex executive informed Wal-Mart International's general counsel of "irregularities" authorised by senior WalMex executives.

In response, Wal-Mart hired an outside firm to perform an initial inquiry, which resulted in a recommendation for a full investigation. This recommendation was rejected by Wal-Mart senior management. Instead, they assigned an internal Wal-Mart team to investigate the matter. The internal Wal-Mart investigators also recommended a broader investigation. Again, however, Wal-Mart senior management rejected this recommendation, instead referring the matter back to WalMex's general counsel, who also was reportedly one of the primary players in the alleged bribery scheme. The WalMex general counsel concluded that there were no violations and recommended no disciplinary action against any WalMex executives.

IBEW demands information

In June 2012, based on the allegations reported in *The New York Times*, Wal-Mart shareholder IBEW requested documents to investigate WalMex's alleged illegal bribery payments and how Wal-Mart investigated those allegations, in order to determine whether it should proceed with a derivative action against Wal-Mart. Wal-Mart withheld certain responsive documents, including documents protected by attorney-client privilege or attorney work product doctrine, and redacted others without explanation. IBEW then filed a complaint in the Delaware Court of Chancery pursuant to Delaware Code Title 8, Section 220 based on Wal-Mart's alleged deficiencies in the document production. After further similar disputes, IBEW notified the Delaware Court of Chancery that Wal-Mart's document

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production still did not comply with the court's most recent order. The court then conducted a Section 220 trial on the basis of the paper record, to determine whether Wal-Mart had produced all of the documents responsive to IBEW's demand. Ultimately, the court sided with IBEW and issued a sweeping order that required Wal-Mart to produce all of the documents requested by IBEW and some additional documents, including documents protected by attorney-client privilege or attorney work product doctrine.

Wal-Mart appeals

The parties filed cross-appeals on a number of issues, with Wal-Mart arguing that the Delaware Court of Chancery had improperly adopted the fiduciary exception to attorney-client privilege to allow the plaintiff to access privileged documents. The Delaware Supreme Court concluded that all of the issues raised on appeal were without merit and affirmed the court of chancery's order. In assessing Wal-Mart's claim that its communications were protected by attorney-client privilege, the Delaware Supreme Court officially adopted the fiduciary exception to attorney-client privilege, which was first recognised by the Fifth Circuit Court of Appeals in *Garner v Wolfenbarger*.⁽⁶⁾ The Delaware Supreme Court quoted *Garner*, which explained the fiduciary exception thusly:

"The corporation is not barred from asserting [attorney-client privilege] merely because those demanding information enjoy the status of stockholders. But 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."⁽⁷⁾

Wal-Mart Stores, Inc, like *Garner*, "allows stockholders of a corporation to invade the corporation's attorney-client privilege in order to prove fiduciary breaches by those in control of the corporation upon showing good cause".⁽⁸⁾ The Delaware Supreme Court held that this rule should apply in plenary stockholder/corporation proceedings as well as Section 220 actions.⁽⁹⁾

The court further concluded that IBEW had satisfied its burden to show good cause why the privilege should not be invoked to protect Wal-Mart's documents. In a footnote, the court quoted the following factors listed in *Garner* as relevant to the good cause inquiry:

- the number of shareholders and the percentage of stock they represent;
- the good faith of the shareholders;
- the nature of the shareholders' claim and whether it is obviously colourable;
- the apparent necessity or desirability of the shareholders having the information and the availability of it from other sources;
- whether the shareholders' claim relates to potentially criminal behaviour, less serious illegal behaviour or behaviour of doubtful legality;
- whether the communication at issue concerns advice on the litigation itself;
- whether the shareholders have identified specific communications or whether they are blindly fishing; and
- the risk of revealing trade secrets or other information in which the company has an interest in keeping confidential for independent reasons.⁽¹⁰⁾

In holding that IBEW had satisfied this good cause test, the court focused on five factors, which may provide a hint as to how Delaware courts will interpret the fiduciary exception. The court held that IBEW could access the privileged documents because:

- the documents related to the investigation itself and were thus necessary to the claim and unavailable by other means;
- IBEW sought specific documents rather than engaging in a fishing expedition;
- the documents did not contain trade secrets;
- the allegations implicated potentially criminal conduct; and
- IBEW was a "legitimate stockholder as a pension fund."⁽¹¹⁾

The Delaware Supreme Court acknowledged that attorney-client privilege plays a "critical" role in "promoting broader public interests in the observance of law and administration of justice".⁽¹²⁾ Accordingly, the court intended the fiduciary exception to be "narrow, exacting, and ... very difficult to satisfy".⁽¹³⁾

Comment

For companies incorporated in Delaware, *Wal-Mart Stores, Inc* weakens the protection from disclosure provided by attorney-client privilege. The *Garner* factors listed in *Wal-Mart Stores, Inc* provide a roadmap for plaintiffs seeking to pry into a company's privileged documents. Now, when a Delaware company conducts an investigation into any type of potentially criminal conduct, documents that do not contain trade secrets may be subject to disclosure if the company faces a particularised demand from a "legitimate" shareholder. This could lead companies to revise their methods of conducting or documenting investigations, or of communicating with the board of directors or subsidiaries, as they strive to keep privileged communications confidential.

Companies centred outside of Delaware may face the same risks if they are drawn into Delaware court. Because of Delaware's business-friendly laws, more than 1 million companies – including more than 50% of all publicly traded companies and over 64% of Fortune 500 companies – have a legal presence in the state and may be subject to a lawsuit there.⁽¹⁴⁾ Wal-Mart, for example, is a worldwide company headquartered in Arkansas, but it must follow Delaware law because it has been incorporated in the state.

There may be additional confusion for companies subject to suit in jurisdictions that take differing views on the fiduciary exception to attorney-client privilege. In California, for example, state courts do not recognise the fiduciary exception, instead viewing a company's privileged communications as protected by the business judgement rule.⁽¹⁵⁾ For companies that may face suit in both Delaware and California, it will be difficult to know contemporaneously whether communications with attorneys will be protected from disclosure by attorney-client privilege. For California companies in particular, *Wal-Mart Stores, Inc* may lead to an erosion of attorney-client privilege as companies conform their attorney-client communications to the Delaware standard. If the rule announced in *Wal-Mart Stores, Inc* is not kept "narrow," it may have unintended consequences that impede a company's ability to get the best legal advice possible.

Indeed, other courts, including federal district courts, have refused to adopt the fiduciary exception for similar reasons.⁽¹⁶⁾ One court that refused to adopt the exception explained that there was "no sufficient reason" to recognise a fiduciary exception in light of the already recognised exception to attorney-client privilege when there are "communications in furtherance of contemplated or ongoing criminal or fraudulent conduct".⁽¹⁷⁾ Courts have also refused to adopt *Garner* based on its conflict with *Upjohn Co v United States*.⁽¹⁸⁾ a 1981 US Supreme Court case that emphasised the importance of attorney-client privilege to a company. These courts take the view that it is ultimately within the shareholders' best interest to promote frank discussion between corporate management and attorneys, and that an "uncertain and unpredictable rule . . . or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all".⁽¹⁹⁾

In assessing the immediate impact of *Wal-Mart Stores, Inc*, it is important to remember that IBEW was able to access Wal-Mart's privileged documents only to determine whether to file a lawsuit, not to publicise or otherwise use them. In the long term, there is a risk of courts gradually expanding the fiduciary exception beyond the factual scenario at issue in *Wal-Mart Stores, Inc*. In many other jurisdictions that have adopted the fiduciary exception, it has been stretched beyond the original creation in *Garner* to justify allowing one party to access the privileged documents of another in a host of other circumstances. For example, courts have applied the fiduciary exception to class action and individual suits relating to general and limited partnerships, joint ventures, pension plans, bankruptcy creditors and real estate transactions, and even to prosecutors and public officials.⁽²⁰⁾

It remains to be seen whether Delaware courts will broaden the fiduciary exception to contexts outside of shareholder derivative suits or keep it "narrow, exacting, . . . and very difficult to satisfy". But even if the rule in *Wal-Mart Stores, Inc* is not expanded, it provides strong arguments for lawyers representing shareholders who want to access a company's privileged documents. In *Wal-Mart Stores, Inc*, the court relied on factors (ie, internal documents related to an investigation that do not contain trade secrets, "legitimate" shareholders, and potentially criminal conduct) that will be present in a great deal of future cases. Going forward, company counsel everywhere should evaluate the decision to assess whether it should change how they conduct corporate investigations.

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Endnotes

(1) ___ A3d ___, 2014 WL 3638848 (Del July 23 2014).

(2) This approach has been adopted by a majority of US courts. See, for example, *In re Dow Corning Corp*, 261 F3d 280, 286 (2d Cir 2001); *Sandberg v Va Bankshares, Inc*, 979 F2d 332, 352 (4th Cir 1992); *Fausek v White*, 965 F2d 126, 130 (6th Cir 1992); *Stenovich v Wachtell Lipton Rosen & Katz*, 756 NYS2d 367, 380 (NY Sup Ct 2003).

(3) See "About Agency", corp.delaware.gov/aboutagency.shtml; see also "Why Corporations Choose Delaware", corp.delaware.gov/whycorporations_web.pdf.

(4) *McDermott, Will & Emery v Superior Court*, 83 Cal App 4th 378, 385 (2000).

(5) David Barstow, "Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle", *NY Times*, April 21 2012.

(6) 430 F2d 1093 (5th Cir 1970).

(7) *Wal-Mart Stores, Inc*, 2014 WL 3638848 at *9-10 (quoting *Garner*, 430 F2d at 1103-04).

(8) *Id* at *10.

(9) The court also clarified that the *Garner* exception does not apply to documents that are protected by the attorney work product doctrine, but the good cause factors used in *Garner* overlap with the required showing under the work product doctrine in Delaware Court of Chancery Rule 26(b)(3). Under Rule 26(b)(3), which substantially mirrors Federal Rule of Civil Procedure 26(b)(3), a party may

discover attorney work product upon a showing that the documents sought are not otherwise discoverable and there is a substantial need for the materials, which the party is unable to obtain by other means without suffering undue hardship.

(10) *Wal-Mart Stores, Inc*, 2014 WL 3638848 at *10 n32 (quoting *Garner*, 430 F2d at 1104).

(11) *Id* at *12-13. The court did not explain why IBEW was a "legitimate stockholder" or what type of stockholder would be viewed as illegitimate.

(12) *Id* at *11 (internal alterations and citations omitted).

(13) *Id*.

(14) See "About Agency", corp.delaware.gov/aboutagency.shtml.

(15) See, for example, *McDermott, Will & Emery*, 83 Cal App 4th at 385. California does not permit judicially created exceptions to the attorney-client privilege, according to longstanding precedent. For example, *Dickerson v Superior Court*, 135 Cal App 3d 93, 99 (1982).

(16) See, for example, *Milroy v Hanson*, 875 F Supp 646, 651-52 (D Neb 1995); *Shirvani v Capital Investing Corp, Inc*, 112 FRD 389, 390-91 (D Conn 1986).

(17) *Shirvani*, 112 FRD at 391 (quoting *In re Grand Jury Subpoena Duces Tecum*, 731 F2d 1032, 1038 (2d Cir 1984)).

(18) 449 US 383 (1981).

(19) *Lefkowitz v Duquesne Light Co*, Civ A. Nos 86-1046 and 86-2085, 1988 WL 169273, at *6 (quoting *Upjohn Co*, 449 US at 393) (internal quotation marks omitted).

(20) See Benjamin Cooper, *An Uncertain Privilege: Reexamining Garner v Wolfenbarger and Its Effect On Attorney-Client Privilege*, 35 Cardozo L Rev 1217, 1231 (citing cases). To underscore the unpredictability surrounding *Garner*, at least one court has refused to apply the fiduciary exception in a shareholder derivative suit, the very type of lawsuit at issue in *Garner*. See also *id* at 1238 (citing *Weil v Investment/Indicators, Research & Management, Inc*, 647 F2d 18, 23 (9th Cir 1981)).

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