A hunt for justice erodes the attorney-client privilege

David Conaway explains the Garner exception to the rules of attorney-client privilege

DAVID H. CONAWAY
Chairman of the Bankruptcy, Insolvency and Creditors' Rights Group, Shumaker, Loop & Kendrick, LLP (USA)

In a highly regulated environment, it is challenging for US corporations to maintain 100% compliance with each and every law touching them.

When issues arise, US corporations rely on the ability to have full and frank discussions with their legal counsel to assess risk and take corrective action to minimize loss. The possibility to have such private discussions is based on the attorney-client privilege, which prohibits legal counsel from divulging privileged communications to any third party.

Although the attorney-client privilege is quite strong, one of the world's largest public companies learned it is not absolute. The Delaware Supreme Court, in *Wal-Mart Stores, Inc. vs. Indiana Electrical Workers Pension Trust Fund IBEW*, ruled that in-house counsel's legal advice to management was not protected by the attorney-client privilege.

Background facts

In 2012, the *New York Times* reported about a scheme of alleged illegal bribery payments from Wal-Mart's Mexican subsidiary, Wal-Mart de Mexico, S.A. de C.V. ("WalMex") to Mexican government officials, allegedly at the direction of WalMex' then CEO. The New York Times indicated that Wal-Mart management knew about the allegations as far back as 2005 and attempted to "whitewash" any evidence of illegality.

Wal-Mart conducted an internal investigation, led by WalMex' general counsel, who concluded that there was no evidence of wrongdoing. In response, a Wal-Mart shareholder, owning less than half a percent of Wal-Mart's stock, initiated an investigation, in furtherance of asserting claims against Wal-Mart's officers and directors for breaches of fiduciary duties owed to shareholders. As part of the investigation, the shareholder sought production of documents and communications between in-house counsel and management under Title 8, Section 220 of the Delaware Code, which allows shareholders to review books and records for a "proper purpose." Wal-Mart refused production, based on the attorney-client privilege. The shareholder, in turn, requested the Delaware court to compel turnover.

Delaware court ruling

In ruling the attorney-client privilege did not protect the documents and communications in this case, the *Wal-Mart* case relied on an exception to the attorney-client privilege, first

Share your views!

recognised over forty years ago in the Fifth Circuit US Court of Appeals case of *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970). The so-called *Garner* exception arises in shareholder suits alleging officer or director actions that are adverse to the shareholders' interests. In such cases, shareholders can obtain privileged information to establish facts to support claims for the breach of fiduciary duties by officers or directors. To prevail, shareholders must demonstrate "good cause" based on several factors, including:

- the number of shareholders and the percentage of stock they represent;
- the "*bona fides*" of the shareholders;
- the nature and viability of the shareholders' claims;
- the necessity of having the information and its availability from other sources;
- whether the alleged actions are potentially criminal or illegal;
- whether the communication is related to past or to prospective actions;
- whether the communication relates to the alleged wrongdoing or the litigation itself;
- whether the communication is identified or is a fishing expedition; and
- the risk of public disclosure of trade secrets or other confidential information.

The Delaware Supreme Court found that the pension fund showed "good cause" to apply the *Garner* exception because essential information was not available from non-privileged or public sources. The Court attempted to balance the competing interests of preventing corporations from hiding corporate wrongdoing and preserving open and honest communication between in-house counsel and their corporate clients. While the Delaware court recognised that the attorney-client privilege is essential in allowing clients to freely discuss possible legal issues with counsel without fear of legal discovery, the Court believed that corporations could abuse the privilege and purposefully conceal evidence of wrongdoing. The court noted, however, that any exception to the attorney-client privilege should be "*narrow, exacting, and intended to be very difficult to satisfy.*" If a corporation is committing wrongful acts, the harmed shareholders should be able to evaluate the acts of the corporation.

Although US state courts have been split on the *Garner* exception, its adoption by the influential Delaware court will no doubt reinforce the Garner exception in future shareholder litigation.

Worth mentioning

In connection with the alleged Mexican bribery payments, the US Department of Justice and the Securities and Exchange Commission (SEC) have ongoing investigations of Wal-Mart's activities that began in November 2011.

There is also a shareholders' securities fraud class action case against Wal-Mart in the Arkansas federal court. Thus far, the SEC has refused to turn over to Plaintiff materials developed in the SEC's investigation.

Takeaways

1. The Wal-Mart case dealt with in-house counsel. As a result of the holding, similar challenges to attorney-client privilege are likely to arise with respect to external counsel, which could lead to this same outcome. Consequently, shareholders in Section 220 and derivative suits in Delaware may now be entitled to production of both in-house and outside counsels' work-product and communications relating to alleged breaches of fiduciary duty, including documents produced during the course of an internal investigation.

2. In the post-financial collapse era, scrutiny of corporate activity is certainly elevated. It is likely that courts faced with any corporate action involving criminal or illegal corporate activity will more readily apply the *Garner* exception and waive the attorney-client privilege. Perhaps "lesser" breaches of fiduciary duty might withstand the *Garner* exception.

3. Arguably the risk of illegal activity is greater in foreign jurisdictions where "rogue" managers or officers are operating in a less disciplined environment. US corporations would be well advised to focus on a vigorous corporate policy and training including with respect to the US Foreign Corrupt Practices Act (and other countries' versions of the same).

4. It may also be advisable for US corporations to consider in appropriate cases confidentiality agreements and arbitration clauses with shareholders that could limit disclosure of privileged information, as an effort to protect legitimate confidential commercial information, and head off additional investigations by various US government agencies.

5. The Wal-Mart case also illustrates the difficult position of corporate counsel, when confronted with the ethical obligation to not divulge communications while being a target of investigators or prosecutors seeking the information. To protect counsel and their employers, companies should consider strategies on evaluating and investigating allegations of illegal activity, including (1) memorialising (or not) results of investigations, (2) limiting the number of parties involved in the process, (3) protecting information such as attorney-client privileged or attorney work product, and (4) involving third parties to conduct investigations. ■

> **ALTHOUGH THE ATTORNEY-CLIENT PRIVILEGE IS QUITE STRONG, ONE OF THE WORLD'S LARGEST PUBLIC COMPANIES LEARNED IT IS NOT ABSOLUTE**