A Cautionary Lesson for Boards When Faced With Shareholder Demands for Books and Records

Jeffrey I Lang, Colin C Bridge

In its April 26, 2023 opinion in *Ontario Provincial Council of Carpenters' Pension Trust Fund v. Walton*, the Delaware Court of Chancery provides a cautionary lesson for corporate boards and their counsel on the risks of sharply limiting the scope of responses to shareholder demands for information. No. 2021-0827-JTL, 2023 WL 3093500 (Del. Ch. April 26, 2023).

In *Walton*, the court denied the defendants' motion to dismiss, in large part due to Walmart's decision to both extensively redact and withhold as privileged documents the company produced in response to a books and records demand under Delaware law.

While the *Walton* decision arose in the context of a motion to dismiss a derivative case on the ground of demand futility, Vice Chancellor Travis Laster's guidance can be extrapolated to the broader context of discovery in shareholder and other litigation.

Background

The decision in *Walton* denied a motion to dismiss a shareholder derivative action asserting *Caremark* claims against Walmart Inc.'s officers and directors arising out of Walmart's role in the national opioid epidemic.

Under the *Caremark* decision, directors of a corporation have a duty of oversight that generally requires the board to implement controls and an information and reporting system, and to respond to "red flags" indicating a risk of corporate misconduct. *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); *see also In re McDonald's Corp. S'holder Derivative Litig.*, 291 A.3d 652, 676 (Del. Ch. 2023) (comparing information and reporting system claims and "red flag" claims).

To prevail on a *Caremark* theory, a "plaintiff must show that a fiduciary acted in bad faith." *Marchand v. Barnhill*, 212 A.3d 805, 820 (Del. 2019). As a number of courts have observed, *Caremark* claims are "'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'" *In re Boeing Co. Derivative Litig.*, No. CV 2019-0907-MTZ, 2021 WL 4059934, at *24 (Del. Ch. Sept. 7, 2021).

In the operative complaint in *Walton*, filed Feb. 22, 2022, the shareholder-plaintiffs alleged that the board knowingly allowed Walmart to fail to satisfy compliance obligations in a 2011 settlement agreement between the company and the DEA as well as the requirements of the federal Controlled Substances Act.

In November 2022, Walmart announced that it had reached a $3.1 billion nationwide opioid settlement that would resolve lawsuits by state, local, and tribal governments. The company, however, still faced a Department of Justice civil action as well as a substantial number of private lawsuits.

The shareholder-plaintiffs sought to shift responsibility for Walmart's financial and reputational harm to the company's directors and officers, advancing three types of *Caremark* claims: (i) the board failed to establish an information and monitoring system; (ii) the directors failed to react despite clear notice of potential corporate harm; and (iii) the directors consciously allowed the corporation to violate the law to increase profits.

Before commencing their action, the shareholder-plaintiffs submitted a books and records demand on Walmart pursuant to Section 220 of the Delaware General Corporation Law. Shareholder-plaintiffs increasingly have made books and records demands before filing suit in order to meet the pleading requirements to state a derivative claim. *See, e.g.*, *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019); *In re Boeing Co. Derivative Litig.*, No. CV 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021); *In re McDonald's Corp. S'holder Derivative Litig.*, 291 A.3d 652, 680 (Del. Ch. 2023).

Walmart ultimately produced documents, including relevant board minutes and exhibits, and certified that the produced documents, together with those withheld and listed on a privilege log, were complete with respect to every category of responsive documents.

In light of Walmart's certification, if the record lacked documentary evidence relating to a particular event, and if it would be reasonable to expect that documentation would exist if the event occurred, then the shareholder-plaintiffs would be entitled to a reasonable inference that the event did not occur. *Walton*, 2023 WL 3093500, at *2.

The parties also executed a confidentiality agreement that stated any complaint subsequently filed would be deemed to incorporate by reference the entire books and records production. *Id.*, at *3. The incorporation-by-reference condition enables a defendant to challenge a complaint on the basis of the incorporated documents.

While a court cannot weigh evidence on a motion to dismiss, the court may review documents to assess whether an inference sought by the plaintiff is reasonable, *e.g.*, whether the plaintiff seeks an inference based on a mischaracterization of a document incorporated by reference. *Walton*, 2023 WL 3093500, at *3.

Walmart moved to dismiss the derivative complaint, asserting that the shareholder-plaintiffs failed to support a reasonable inference of demand futility, and submitted 87 documents from the books and records production in support of its motion. *Walton*, 2023 WL 3093500, at *3.

In order to pursue a derivative action, a shareholder must either (i) first demand the directors pursue the claims and have the demand wrongfully refused; or (ii) allege that demand is excused because the directors are incapable of reaching an impartial decision regarding the claims. Del. Ch. Rule 23.1; *United Food & Commercial Workers Union v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. Sept. 23, 2021).

At the time the complaint was filed, there were 12 directors on the Walmart board, eight of whom were named in the derivative complaint because they were on the board during the relevant period.

The complaint alleged that demand was excused on the ground that a majority of the directors at the time were incapable of making an impartial decision because they faced a substantial likelihood of personal liability on the asserted claims, one of the factors courts use to analyze demand futility.

Although a court must accept as true all of the complaint's well-pleaded allegations and draw all reasonable inferences in the plaintiff's favor, *see Zuckerberg*, 262 A.3d at 1048, Walmart argued that the documents it submitted refuted any reasonable inference that a majority of directors faced a substantial likelihood of personal liability.

According to Walmart, those documents, including board minutes, showed that the directors solicited and received extensive legal advice on the matters at issue, and the court should reasonably infer that the directors acted in good faith and made informed decisions. *Id.*, at *4.

Decision

Vice Chancellor Laster dismissed one claim, but he denied Walmart's motion to dismiss claims relating to the DEA settlement and Walmart's noncompliance with the Controlled Substances Act.

In his opinion rejecting Walmart's arguments, Laster explained that he could not conclude that the directors made reasoned decisions, or any decisions at all concerning the company's compliance with the DEA settlement or the Controlled Substances Act, because Walmart had extensively redacted the documents produced: "In many cases, only a few words survive. The resulting documents indicate that a topic was addressed, but the redactions deprive the court of insight into the context, the substance of the discussion, and any decision that might have been made." *Id.*, at *3.

Significant portions of the board minutes Walmart relied on had been redacted on the basis of attorney-client privilege. Laster acknowledged that he could not draw inferences about the content of communication redacted for privilege. But the redacted documents left little to show what was actually discussed and decided by the board, content that ordinarily would not be subject to privilege.

Accordingly, Laster *did* draw inferences from what was *missing* in the redacted board minutes, specifically the absence of references to the board's discussions and decisions regarding the critical issues raised in the complaint. While legal advice, properly redacted for privilege, "undoubtedly is an input into those discussions and decisions, [] if directors and officers are doing their jobs, then there will be non-privileged discussions and decisions about what are inherently and ultimately business decisions (which the business judgment rule generally will protect)." *Id.*, at *3.

Walmart also redacted part of documents—even parts of sentences—on the basis of non-responsiveness. A company may redact material unrelated to the subject matter of a demand. *Okla. Firefighters Pension & Ret. Sys. v. Amazon.com, Inc.*, 2022 WL 1760618, at *13 (Del. Ch. June 1, 2022). However, the breadth and nature of Walmart's redactions troubled the court. For example, Walmart redacted parts of sentences—which Laster characterized a "dubious" practice, "because it depends on the premise that the author incoherently injected an unrelated topic into an otherwise responsive sentence." *Walton*, 2023 WL 3093500, at *3.

In response to Walmart's argument that the privileged documents and passages showed that the board and its committees received reports on compliance issues, Laster observed that this was "a fair inference to draw, and this decision assumes that to be the case." *Id.*, at *4.

Indeed, it is clear from the opinion that Walmart had an information system in place and that the board received regular reports from management and counsel. *See, e.g., id.*, at *39 (summarizing updates and reports about compliance efforts received by one of the Walmart directors); *id.*, at *35 (noting that "the

contention is not that Walmart did nothing on the compliance front. The pleading-stage record shows that Walmart initially drafted an extensive set of policies and procedures.").

But the critical issue, given that the shareholder-plaintiffs had asserted a "red-flags" claim, was whether there was anything in the documents from which to draw a reasonable inference about the board's discussions and decisions in response to reports about the status of its opioid compliance. On that matter, the board documents shed no light.

Based on the record before him, Laster could have inferred, for example, that the board concluded that Walmart's compliance efforts were on track. But he could have just as reasonably inferred that the board concluded that Walmart's compliance efforts were inadequate and failed to react. "The passages and documents for which Walmart asserted privilege could inferably cloak reports that Walmart had not devoted sufficient resources" to the matters at issue. *Id.*, at *4.

For example, in November 2014, the board reviewed the status of Walmart's actions to comply with the DEA settlement. Walmart withheld the meeting minutes in their entirety on the basis of privilege. The practical effect of Walmart's assertion of privilege over the minutes in their entirety was a representation "that the Board did not discuss any business topics, evaluate any business considerations, or make any business decisions." *Id.*, at *37.

Because of Walmart's "compulsive" redactions, Laster was compelled to draw the plaintiff-friendly inference that the directors "knew that Walmart was not in compliance with the DEA Settlement, knew that Walmart could not achieve compliance by the time the DEA Settlement terminated, and consciously did nothing to bring Walmart into compliance." *Id.*, at *41.

Since he did not see the complete Walmart board minutes, Laster did not consider whether the redactions were appropriately limited to privileged material. But he intimated a concern that the redactions were informed by litigation strategy, to his frustration and Walmart's detriment.

In the Laster's view, Walmart's redactions "played into the plaintiffs' hands." Without any record of the directors' decisions on the critical issues, let alone their deliberations and reasoning, the Vice Chancellor was "reluctantly" compelled to accept the inference urged by the shareholder-plaintiffs—that even outside directors with commendable records of honorable public and reputable private service did not act in good faith and faced a substantial risk of personal liability, ultimately making demand futile.

Significance

The *Walton* decision certainly is not dispositive, and Walmart will have additional opportunities to produce fuller versions of the relevant board minutes—and if they are helpful, to take advantage of evidentiary presumptions. But the denial of Walmart's motion to dismiss is consequential. Rather than dismissal, the case will proceed to discovery, increasing the cost of the litigation and, perhaps more importantly, the potential negotiating leverage of the shareholder-plaintiffs.

Vice Chancellor Laster's opinion in *Walton* betrayed an impatience with boards that produce extensively redacted board minutes, particularly those that appear to obscure directors' deliberation and decisions on important business matters—and not for the first time.

Laster previously had warned boards about the risks of withholding from discovery board minutes and related materials in *In re McDonald's Corporation Shareholder Derivative Litigation*. In that case, while he granted the director defendants' motion to dismiss *Caremark* claims in connection with sexual harassment allegations involving the CEO and the head of human resources, he considered the plaintiffs' assertion that the absence of board minutes of prior meetings concerning the allegations against the CEO supported an inference of bad faith.

Laster noted that the absence of board minutes can pose a substantial risk to directors. He explained that "failure to keep minutes can be a cause for suspicion…It also may backfire, as it deprives the defendants and the court of the benefit of account of what took place, prepared close in time to the events themselves." 291 A.3d 652, 692 (Del. Ch. 2023). But McDonald's did produce minutes for the meeting in which the board approved the CEO's $47.5 million separation agreement, and those minutes reflected both the board's informed deliberations and its decision.

On those and other facts, Laster held that the lack of minutes relating to the board's initial meetings concerning the allegations against the CEO was "not sufficient to support an inference of bad faith." *Id.* at 692.

Corporate boards and their counsel often try to limit the scope of disclosure in response to books and records requests—and often for good reason. Boards have a responsibility to avoid the risk of disclosing confidential and propriety information, as well as information protected by the attorney-client privilege.

The *Walton* decision, however, teaches the importance of documenting board deliberations and decisions to ensure that directors can invoke evidentiary inferences and presumptions under Delaware and other states' laws, and the related risk to those evidentiary inferences and presumptions posed by overzealous limitation and redaction of disclosed materials.

There are several important lessons to be drawn from the *Walton* decision:

First, boards should establish an effective monitoring and information reporting infrastructure. One of the plaintiffs' claims in *Walton* was that the director defendants did not make a good faith effort "to implement and monitor internal reporting policies and systems." *Walton*, 2023 WL 3093500, at *27.

The *Caremark* line of cases makes it clear that a board cannot discharge its oversight responsibility if it does not have a system in place to ensure that it is informed about key business issues and risks.

In adopting the *Caremark* standard, the Delaware Supreme Court explained "[i]n the absence of red flags, good faith in the context of oversight must be measured by the directors' actions 'to assure a reasonable information and reporting system exists.'" *Stone v. Ritter*, 911 A.2d 362, 373 (Del. 2006) (affirming dismissal of derivative complaint for failure to excuse demand) (quoting *Caremark*, 698 A.2d at 971).

The information system, moreover, should be reasonably tailored to monitor the company's central compliance risks. For example, in a derivative suit alleging that directors of an ice cream manufacturer breached *Caremark* duties by failing to monitor contamination risks, the directors argued that they satisfied their duties because they received regular reports about operational issues.

The Delaware Supreme Court concluded that board discussion of general operations was insufficient under *Caremark* and reversed the dismissal of the complaint because the plaintiffs pled facts showing that the company had "no board-level system of monitoring or reporting on food safety," a risk the court described as "mission-critical." *Marchand*, 212 A.3d at 824.

Second, the decision in *Walton* clearly shows that in a properly pled "red-flags" case, a motion to dismiss will be denied if there is nothing in the record to show that the board took action in response to the red flags. Put another way, if the board is going to invoke the protection of the business judgment rule, the board must exercise judgment and make a decision. It is not enough for a board to have an information and reporting system and receive regular updates on key issues if the board is aware of potential harm to the corporation and fails to address it.

In *Walton*, the board received information and updates about risks to achieving compliance with the DEA settlement, but the court concluded that a majority of the directors faced potential liability for bad faith because there was no evidence that they took action in response to the compliance risks. *See Walton*, 2023 WL 3093500, at *37 (noting that "[i]t is reasonable to infer from documents in the record that

Walmart was not in compliance with the DEA Settlement, that the directors knew about it, and that they took no action in response.").

Third, because courts will consider documents produced in response to books and records demands on a motion to dismiss, the board's judgments and actions should be well-documented. Boards and their counsel must ensure that meeting minutes and other board materials properly document the directors' deliberations and decisions on the issues before the board. That section of the board minutes should be separate and apart from any legal advice received by the board.

As already noted, the directors are protected by the business judgment rule—but only to the extent they actually exercise reasonably informed judgment. The board minutes represent the clearest evidence of the directors' exercise of judgment. On a motion to dismiss, if a complaint alleges that the board failed to act or acted in bad faith, and there are two possible inferences concerning the board's conduct, the plaintiff will prevail.

It is unclear in *Walton* if the board minutes failed to reflect the director's decisions because they were poorly drafted, due to overly broad redactions, or, as the court was compelled to infer, because the directors simply failed to engage. Whatever the reason, Walmart's board materials were insufficient to defend the case on a motion to dismiss.

Fourth, boards and their counsel should exercise care when limiting disclosure in response to a shareholder demand for books and records. Boards have legitimate and important reasons to avoid producing non-responsive material, including to avoid unnecessary disclosure of confidential information, and to avoid disclosure of nonresponsive material that might lead to spurious litigation.

And of course, boards have a powerful interest in protecting against a waiver of attorney-client privilege. But the oftentimes reflexive reaction to shareholder demands for books and records—to tightly limit

disclosure—risks a failure to produce information necessary for the board to realize the protections afforded by Delaware and other states' laws.

Fifth, while the *Walton* decision arose in the context of a books and records production, Vice Chancellor Laster's guidance applies as well to the discovery phase in shareholder derivative cases and other litigation.

During the discovery phase of litigation, corporate boards and parties of all stripes often seek to narrowly contain the scope of their document production. An overly restrictive approach to production, even if not sanctionable, risks the preclusion of potentially important evidence. A strategy that sharply restricts the production of nonresponsive and privileged information must be thoughtful enough to recognize situations where documents contain helpful information that might merit production, despite the risks of disclosure, such as the risk of a partial waiver of privilege.

Jeffrey I. Lang *is a partner and* Colin C. Bridge *is counsel at Cohen & Gresser.*