

Attorney-Client Privilege Limits Corporate Director's "Absolute Right"

by

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As many small business owners can tell you, members of closely-held corporations often have two concurrent roles: director and shareholder. While an individual can hold both roles, each carries with it different sets of rights and duties. The line between the two may seem arbitrary and at first glance inconsequential, but classification can become a critical issue during litigation. Which "hat" should a corporate director be allowed to wear when they file a shareholder derivative action?

The rights and differences accompanying each role are not just important for business development and corporate purposes, but must be understood by trial attorneys as well. Corporate directors have an absolute right to "inspect and copy all books, records, and documents of every kind". Cal. Corp. Code § 1602. Shareholders on the other hand have an absolute right to inspect accounting books, records and minutes when they reasonably relate to their interest as a shareholder. Cal. Corp. Code § 1601. The distinction may seem subtle on the surface, however in the context of discovery the difference can propound or exclude a mountain of evidence that will make or break the case. Compared to the director's absolute right, the scope of the shareholder's right is limited by the *reasonable relation* requirement. *Id.* A shareholder's request is reasonably related to their interest when an inspection is "necessary or proper for the protection of [the shareholder's] interest or for [the shareholder's] information as to the condition of the corporation and the value of [the shareholder's] interests therein." *Schnable v. Superior Court* (1993) 5 Cal.4th 704, 716. Shareholder's rights of inspection are generally tied to valuation of their stock. The requirement prevents discovery of many corporate documents, which may include those specifically prepared for litigation. Obviously, a director filing a shareholder derivative action stands to benefit if able to exercise the broad director right of inspection as opposed to the narrower shareholder right. In *Tritek Telecom Inc. v. Superior Court of San Diego County (Real Party in Interest Mak)* (2009) WL 32861 (Cal.App.4th), the Fourth Circuit Court of Appeals addressed this loophole declaring that a shareholder is not able to exploit his or her position as director to demand unlimited access to all corporate documents in their own shareholder derivative action.

The dispute behind *Tritek* is not unusual in the world of closely-held corporations. Each party, holding equal power in all matters, held divergent opinions regarding corporate operations and individual salary. Most attorneys have undoubtedly encountered the same dispute time and time again: who has power and who gets the money. At the time of the conflict *Tritek's* two shareholders, Mak and Rerolle, also happened to be the sole members on the board of directors. Tensions eventually boiled over, with Mak filing a shareholder derivative action seeking a return of his investment and damages against the corporation and Rerolle. *Tritek*, operating through Rerolle, sprung into defense counterclaiming against the fellow director for corporate improprieties. *Id.*

During discovery, Mak, who used his right as a shareholder to file the action, sought to switch hats and benefit from his power as director. Mak petitioned the trial court to enforce his right as a director and allow a complete inspection of Trittek's books and records. Recall that normally under Cal. Corp. Code § 1602, corporate directors have an absolute right to inspect all corporate documents. A complete inspection of Trittek's books and records would have produced documents directly relating to the litigation, including direct communications between Rerolle and his attorney. Not asleep at the wheel, Trittek and Rerolle challenged the petition asserting that attorney-client privilege protected documents specifically generated in defense to the action. However, the trial court granted Mak's petition, ordering Trittek to produce all files relating to the shareholder action, all communications between the Trittek's legal team and officers, directors or employees of Trittek, and all other litigation files regarding Trittek. In effect, the trial court allowed Mak to switch hats and benefit from the fully array of his rights. Trittek challenged the order, continuing to assert attorney-client privilege. *Id.* at 2.

The Fourth Circuit Court of Appeals, while acknowledging that directors have an absolute right to "inspect and copy all corporate books, records and documents of every kind", reversed the trial court's ruling declaring that the absolute right is subject to exceptions. The right to inspect stems from the legislature's belief that directors are better able to perform their fiduciary duties if they have free access to all information regarding the corporation. However when a director frustrates his own ability to adequately perform the fiduciary duty, the right has potential to lose its purpose. Without the purpose the court will not recognize the right. This notion is not entirely uncommon in corporate law. For example, while it is generally presumed that a director is acting in good faith, a court will only apply the business judgment rule to disinterested directors. Directors who are not disinterested are subject to a different form of scrutiny under the law. *Id.* at 3.

By filing a shareholder derivative action, Mak had divided his loyalties and was no longer a disinterested director. The fact that Mak sought to enforce his inspection rights only after filing the shareholder derivative action highlights this division: he sought to use his rights in a manner a disinterested director would not. While Mak hadn't entirely lost his status as a director, his actions made him Trittek's adversary. As his own corporation's adversary, Mak could not take advantage of his position as director because it would frustrate the legislative intent behind the right to inspect. The court's language is clear:

Mak cannot take off his "shareholder's hat" and swap it for his "director's hat" and claim an absolute right to access all corporate documents. In this situation, a court may properly limit a director's inspection rights because the director's loyalties are divided and documents obtained by a director in his or her capacity could be used to advance the director's personal interest in obtaining damages against the corporation. *Id.* at 4.

While the *Tritek* holding may seem obvious in light of the legislative intent behind corporate director's inspection rights, it solidifies an important exception to the rule. Corporate directors are not always entitled to all of a corporate director's rights in the eyes of the law. A director who has become an adversary to his corporation loses the absolute right of inspection during discovery. The *Tritek* holding operates as a lesson in both understanding rights and being aware of limits. It is imperative to recognize what documents your client is entitled to in a shareholder derivative action, but it is just as important, if not more pressing, to be aware of when you must assert a privilege to prevent discovery. When considering a shareholder derivative suit for a corporate director, be prepared for the fact that your client will lose some of the rights otherwise enjoyed. Likewise do not surrender documents based upon an "absolute right" without first considering all legal avenues for avoidance. During the appellate court review, the *Tritek* parties settled the underlying matter. However, if *Tritek* and *Rerolle* had not exerted their attorney-client privilege and simply disclosed the requested documents the outcome might have been different and the settlement less favorable.