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EXPERT ANALYSIS

# Inadvertent Loss of the Attorney-Client Privilege in a Corporate Transaction

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When the parties negotiating a stock purchase or merger agreement devote their attention to the key business terms necessary to get the deal done and advance the business purpose for the transaction, they may overlook addressing the post-closing ownership of the attorney-client privilege in drafting the agreement.

While it is generally understood that the parties are entitled to assert the attorney-client privilege prior to the closing, many would be surprised to discover that the privilege could be transferred to the successor corporation and unavailable to the seller post-closing.

For many sellers and their attorneys, the discovery that the attorney-client privilege could be lost may come when it is too late and post-closing litigation has been commenced by the buyer against the seller over alleged breaches of representations and warranties in the agreement.

This analysis discusses the ownership of the attorney-client privilege in the context of a sale or merger and how to avoid the potential loss of that privilege.

## A GENERAL UNDERSTANDING OF THE TRANSFER OF CORPORATE CONTROL

For good reason, it is generally understood that communications between the officers and directors of a selling corporation and its attorneys regarding the transaction are privileged. Such communications necessarily concern the sensitive business terms of the transaction, including the representations and warranties in the agreement to which the selling corporation will be bound.

However, the passing of corporate control can trigger the transfer of the attorney-client privilege over those communications to the buyer. In the context of a bankruptcy action involving the transfer of control over an entity to an appointed trustee, the United States Supreme Court affirmed this principle when it held that "when the control of a corporation passes to new management, the authority to assert and waive the corporation's attorney-client privilege passes as well." *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 349 (1985).

Thus, "[d]isplaced managers may not assert the privilege over the wishes of current managers, even as to statements that the former might have made to counsel concerning matters within the scope of their corporate duties." *Id.* at 349.

Thus, corporations and their attorneys have had fair warning since the *Weintraub* decision that the right to assert the attorney-client privilege over pre-closing communications between the officers and directors of a selling corporation and its attorneys could be passed to the buyers upon the occurrence of the closing and discoverable by the buyer in subsequent litigation.

*The discovery that the attorney-client privilege could be lost may come when it is too late and post-closing litigation has been commenced.*

## THE *TEKNI-PLEX* EXCEPTION

Significantly, the change of control emphasized in *Weintraub* was not the key consideration in a later action involving a merger transaction under New York law. In 1996, the New York Court of Appeals issued a decision in *Tekni-Plex, Inc. v. Meyner & Landis*, 674 N.E.2d 663 (N.Y. 1996), that upheld the seller's post-closing right to assert the attorney-client privilege against disclosure to the buyer of the seller's communications regarding the negotiations with its attorney.

In *Tekni-Plex*, the seller entered into a merger agreement wherein Tekni-Plex was acquired by the buyer for $43 million. Following the closing and a complete transfer of control, the successor commenced an action against the seller's former sole officer and director for breaches of certain representations in the merger agreement.

During discovery, the buyer demanded the production of the files from the seller's attorney in the transaction, including communications between the seller and its attorney regarding the representations in the agreement at issue in the litigation.

The New York Court of Appeals held that in the context of a merger transaction, the communications between the seller and its attorney had to be dissected between general business communications and those specifically relating to the merger negotiations. With respect to the former, the Court followed *Weintraub* and held that control over the attorney-client privilege for such pre-acquisition communications passed to the buyer.

However, for the specific set of attorney-client communications regarding the merger itself, the Court held that the buyer did not obtain and control the privilege and that it remained with the seller.

As a matter of policy, the Court reasoned that giving the buyer control over the seller's communications with counsel regarding the transaction would thwart the public policy underlying the attorney-client privilege, which is to encourage the "full and frank communication between attorneys and their clients and thereby promote[s] broader public interests in the observance of law and administration of justice." *Id*. at 671 (quoting *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981)).

As the Court explained, "corporate actors should not have to worry that their privileged communications with counsel concerning the negotiations might be available to the buyer for use against the sold corporation in any ensuing litigation. Such concern would significantly chill attorney-client communication during the transaction." *Id*. at 671-672.

Accordingly, the *Tekni-Plex* decision created an exception under New York law such that even when there has been a complete transfer of assets and control, the seller retains the right to assert the attorney-client privilege over the specific communications with its counsel regarding the negotiation of the transaction.

## THE DECISION IN GREAT HILL EQUITY PARTNERS

The *Tekni-Plex* exception was rejected years later by the Delaware Court of Chancery in *Great Hill Equity Partners, IV, LP v. SIG Growth Equity Fund I, LLP*, 80 A.3d 155 (2013).

In *Great Hill,* the surviving corporation in a merger transaction sued the former shareholders of the seller for fraudulent inducement incident to the merger. The merger agreement was governed by and subject to the Delaware General Corporation Law ("DGCL") and did not include any provision excluding the pre-merger communications between the seller and its attorneys from the assets that were transferred to the buyer.

During the subsequent litigation, the seller asserted that the attorney-client privilege precluded discovery of the seller's communications with its counsel regarding the negotiations of the merger agreement.

Unlike the court in *Tekni-Plex*, however, the Delaware Chancery Court held that in the absence of a provision in the merger agreement precluding such a transfer, the privilege over such pre-merger communications transferred with all the other assets to the buyer.

Initially, the Court noted that as a matter of statutory interpretation, Section 259 of the DGCL provided that "all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation." *Id*. at 156.

Declining to read a policy exception into the DGCL, the Court held that Section 259 used "the broadest possible terms" and that the term "all privileges" meant that the attorney-client privilege belonged to the surviving corporation as a matter of Delaware law. *Id*. at 156-157.

Chancellor Strine further addressed the *Tekni-Plex* decision and rejected the notion that a judicial exception to the transfer of the attorney-client privilege should exist under Section 259 of the DGCL. *Id*. at 159-160.

Rather, Chancellor Strine held that parties to such transactions were free to negotiate contractual terms to expressly exclude the transfer of attorney-client communications regarding the negotiation of the agreement from the assets being transferred to the buyer.

Indeed, Chancellor Strine stated that in the "wake" of *Tekni-Plex*, sophisticated corporations and their counsel should have been aware of the numerous cited articles that had been published "encouraging practitioners to take privilege issues into account when negotiating a merger agreement." *Id*. at 161 & n.29.

Coming full circle to emphasize this point, the Court cited to *Weintraub* and held "[t]hus, the answer to any parties worried about facing this predicament in the future is to use their contractual freedom in the manner shown in prior deals to exclude from the transferred assets the attorney-client communications they wish to retain as their own." *Id*. at 162.

In short, the Court issued a clear warning that under Delaware law, "[a]bsent such an express carve out, the privilege over all pre-merger communications — including those relating to the negotiation of the merger itself — passed to the surviving corporation in the merger, by plain operation of clear Delaware statutory law under § 259 of the DGCL." *Id*.

At least two decisions published after *Great Hill* declined to follow *Tekni-Plex* and have instead ruled consistent with the holding in *Great Hill*. *See, e.g.*, *NewSpring Mezzanine Capital II, L.P. v. Hayes*, Civ. No. 14-1706, 2014 WL 6908058, at *4 (E.D. Pa. Dec. 9, 2014) (analysis under federal privilege law); *Novack v. Raytheon Co.*, No. SUCV201302852BLS1, 2014 WL 7506205, at *4 (Mass. Super. Ct. Oct. 24, 2014).

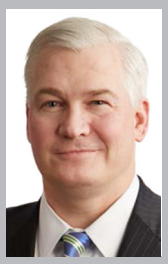
## CAVEAT VENDITOR

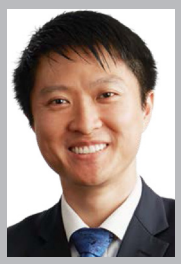
Corporations and their counsel, especially in transactions subject to the DGCL, should follow Chancellor Strine's clear warning in *Great Hill* to draft an express carve out and reservation to the seller of the attorney-client privilege over all pre-closing communications.

Failing to do so could jeopardize a client's right to assert the attorney-client privilege over communications with its attorneys concerning the negotiations of agreements at the very center of post-closing litigation.

For buyers involved in post-closing litigation where a carve out was not included in the agreement, their litigation counsel should immediately make an early demand of all such communications between the seller and its counsel for the deal, especially in any transaction subject to the DGCL.

Given the holding in *Great Hill*, it seems clear that the successor corporation does not even need the predicate of litigation to make such a demand. While this may invite the chilling effect that concerned the Court in *Tekni-Plex*, such a result can easily be avoided by drafting a carve out in all transactional documentation.





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