

By SRS Acquiom

M&A: Who Owns the Attorney-Client Privilege After Closing?

In most mergers, the buyer and seller are each represented by legal counsel. The stockholders of the target company often assume that communications with the law firm that “sat on their side of the table” in the negotiation phase of the transaction will continue to be confidential and unavailable to the buyer since the buyer was the adverse party during the negotiation phase. This analysis, however, fails to take into account the actual nature of the attorney-client relationship. In most deals, the sell-side law firm’s client is the target company, not its stockholders. At closing, the target company typically becomes a wholly owned subsidiary of the buyer. Therefore, there has been some question as to whether rights to the legal privilege and the attorney-client relationship flow to the buyer with respect to pre-closing communications.

In the court decision, *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, C.A. No. 7906-CS (Del. Ch. Nov. 15, 2013), the Delaware Chancery Court addressed this issue and determined that the selling company’s attorney-client privilege covering pre-closing communications transferred to the buyer following closing. The court focused on the statutory language of Section 259 of the Delaware General Corporation Law, which states that following a merger, “all [of the target company’s] 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 . . .” (emphasis added).

The court suggested that the target company could have avoided this outcome by specifically excluding such privilege rights from being transferred to the buyer contractually in the merger agreement. The court went on to cite certain examples of asset purchase transactions in which this was done. In our view, however, there are a number of questions that remain unanswered by the court’s decision. We address those below and suggest possible alternatives to attempting to assign the privilege from the successor entity to a sell-side representative. These alternatives may be useful in addition to, or in lieu of, such an assignment depending on the facts and circumstances of a particular transaction.

A: How does the privilege get assigned to a designated group or assignee?

Under Great Hill, the default rule is that the buyer would ordinarily acquire control of the privilege by virtue of its ongoing ownership and operation of the target company's business following closing. With mergers, this may be bolstered by the fact that the buyer becomes the owner of the surviving legal entity and there is no legal entity separately owned by the pre-closing target stockholders (as in an asset purchase). Therefore, for the assignment to be effective according to Great Hill, the privilege must somehow be transferred out of the surviving or successor company and to another sell-side entity at or prior to closing if it is to be retained by the sell-side.

Such a transfer might not be as simple as the Great Hill court seems to imply when it states that the result in this case could have been easily avoided had the merger parties simply contractually agreed that the applicable privilege would remain with the sell-side following closing. The opinion does not describe what language could have been used, who could properly retain or acquire the privilege, or how that result would become effective. Parties desiring this outcome might state that the privilege with respect to the applicable communications will be held by the target company's pre-closing stockholders but can only be waived by their designated representative, but the court did not clarify why such a provision overcomes the statutory language of Section 259 cited above.¹ For such an arrangement to stand, a reviewing court would have to accept the validity of the mechanism by which the new privilege-holder acquired the privilege and conclude that the procedure resulted in an effective and enforceable transfer.² Since the seller in Great Hill made no effort to include contractual language that would have changed the default rule dictated by Section 259, we believe these remain open issues.

B: Even if the privilege can be transferred, how do the selling stockholders avoid an immediate waiver?

The Great Hill court noted that the target company did nothing to prevent the disclosure of the relevant communications to the buyer for over a year following closing. The court, however, did not address the issue of whether such inaction would have constituted a waiver because it was not necessary to tackle that question once it had already concluded that the buyer owned the privilege following closing.

Therefore, the question remains that even if the target company is successful in preventing the privilege from being transferred to the buyer at closing, how can it prevent that privilege from immediately being waived? A waiver could be deemed to have occurred for a couple of reasons.

First, the privilege could be deemed waived for the reason implied in Great Hill if the buyer obtains access to such communications following closing. Since, in this scenario, a party that the sell-side is arguing does not hold the privilege (the buyer) was able to access the contents of the related communications, a court could find that the applicable privilege has been waived. To address this, the parties could include language in the merger agreement similar to "clawback and non-waiver" provisions

found in protective orders in the discovery context. Such language would state that any post-closing access by the buyer to such communications would not result in a waiver or otherwise affect the rights of the selling stockholders (or their representative) with respect to the related privilege. Since Great Hill did not address that issue, it is unclear whether such a “privilege savings clause” would work.

Second, unless the courts accept a legal fiction that the target company and all of its employees “forget” the privileged information upon transfer to an assignee, pushing them outside the zone of privilege by virtue of a transfer could function as a waiver. Therefore, even if the selling company is successful in preventing the buyer from ever accessing any relevant communications, the fact that parties who no longer “own” the privilege have actual or constructive knowledge of the contents of such communications may still be deemed to cause a waiver of such privilege upon transfer.

C: What is the scope of the communications that should be subject to any privilege retained by the selling stockholders?

Even if the merger parties agree that the sell-side should retain privilege rights related to attorney communications regarding the merger, the buyer is unlikely to agree that this should apply to all pre-closing attorney-client communications. Most buyers are going to insist that they acquire all rights in all pre-closing attorney communications not directly related to the merger transaction since those other communications could be relevant to the ongoing operations of the acquired business. Therefore, assuming a transfer of the privilege is possible, and a waiver can be avoided, the merger parties must also be specific about exactly which communications are covered by the assigned privilege.

In *Tekni-Plex, Inc. v. Meyner & Landis*, 674 N.E.2d 663 (N.Y. 1996), the New York Court of Appeals ruled that privileged communications related to the merger transaction itself were retained by a selling stockholder, but rights with respect to other attorney-client communications were transferred to the buyer at closing. Merger parties might look to the *Tekni-Plex* opinion as a framework in defining which privileged communications would remain with the selling stockholders (and their representative), and which would transfer to the buyer. While this distinction generally makes sense at a high level, there are some communications that would likely fall in a gray area. For instance, if the target company asks its attorneys to do an analysis of third-party intellectual property rights because it wants to understand any risks to its operations, and if that analysis also turns out to be relevant to what it includes in a disclosure schedule attached to the merger agreement, are those communications related to the merger or to the company’s general operations?

Therefore, even if the merger parties agree that privilege rights to pre-closing communications with counsel related to the merger will not be transferred to the buyer, the line as to what is intended to be included and excluded from that definition may be a little fuzzy. To address this, lawyers for the target company may want to designate applicable pre-closing communications with a header similar to “Privileged Attorney-Client Communications Related to the Merger Transaction.”

D: If there remains uncertainty as to whether the privilege may be transferred to the buyer, are “Notices” sections being properly drafted?

Many merger agreements contain a “Notices” provision that says that any post-closing communications to the designated representative of the target’s pre-closing stockholders (a “Representative”) should copy the target’s pre-closing attorneys. If, under the Great Hill decision, the buyer may own the privilege and the attorney-client relationship (or attorney-former client relationship) following closing, then what is the law firm supposed to do if it is copied on any such communications? This is a difficult question if not addressed because the law firm presumably was copied for a reason but could be prohibited from engaging in communications with the Representative if the buyer is deemed the holder of the privilege or is a client or former client at such time. If the firm that represented the target is to be copied, it will want to make clear that the Representative or the stockholders will be deemed the holder of the privilege after closing and that any potential conflicts have been waived.

Possible Solutions:

Given the questions regarding how to assign the privileges outlined above, sellers might want to consider alternatives to protect their interests. The alternatives suggested below are not meant to be independent. They could be used together or in connection with efforts to have the applicable privilege assigned to a sell-side group or representative upon closing.

1. “Quarantine” applicable pre-closing communications with counsel with a covenant from the buyer not to attempt to access them.

When determining how the target company’s merger team and the company’s counsel are going to communicate pre-closing, it may be necessary to set up a communications system separate from the target company’s email system and to specify in the merger agreement that all electronic and hard copies of such communications will be effectively walled off from other company systems and communications.³ The parties could couple this with a provision in the merger agreement in which the buyer and target company covenant not to attempt to access any such communications following closing. This does not prevent the privilege from accruing to the buyer upon closing but makes clear that such communications should be unavailable to it. Finally, if the buyer inadvertently obtains any such communications, the agreement could make clear that such communications cannot be used against the selling stockholders or their Representative, as described in alternative #2 below.

2. Allow the buyer to access the applicable communications but limit permitted uses.

If the parties do not agree that the buyer will be prevented from accessing the applicable communications following closing, they could instead include a clause in the merger agreement providing that the buyer cannot use any such communications or the contents thereof against the selling stockholders (or their Representative) in

connection with any disputes against the selling stockholders related to the merger agreement. As with alternative #1 above, this would not prevent the privilege from transferring to the buyer and has the obvious drawback for the selling stockholders that the buyer would be able to freely see the contents of such communications, but it would ameliorate the risk of those communications being used against them.

3. Execute a common interest agreement (CIA) between the target company and the Representative.

Another alternative to assigning rights to privileged communications or to preventing such rights from being transferred to the buyer in a merger would be to have the target company and the Representative enter into a CIA with the target company and its attorneys prior to closing. The CIA could acknowledge joint access of the target company and the Representative to the privileged material but reserve the right to waive the privilege to the Representative alone. As with alternative #2 above, this likely would not prevent the buyer from accessing privileged materials but could prevent the buyer from disclosing or using such materials in litigation. This presumably would leave the Representative the option to use, or prevent the use of, that material in any dispute.

Furthermore, most CIAs include a provision stating that each party agrees that it cannot use any privileged communications against the other if the parties' interests diverge at any point. Since the interests of the Representative and the target with respect to such communications presumably are aligned prior to closing but may diverge in the event of certain disputes under the merger agreement, this divergence of interests provision in the CIA should further support the argument that the buyer is barred from being able to use the applicable communications in disputes against the selling stockholders.

Additionally, using a CIA may have an added benefit over the preceding alternatives in ensuring the Representative is able to access pre-closing communications with the target's counsel. In Great Hill, the selling stockholders were attempting to prevent the buyer from accessing or using the privileged communications, but the opposite consideration is often in play. Rather than selling stockholders trying to block the buyer's access, the selling stockholders are often interested in obtaining certain materials or communications to bolster their defense against a claim. Having a CIA in place could make clear that the Representative has rights to access such materials.

Finally, implementing a CIA likely would not need the approval of the buyer, which would otherwise be required in order to assign the privilege or to add a covenant or restrictive provision to the merger agreement as contemplated in alternatives #1 and #2 above.

Until the courts are able to further clarify if and how the parties can assign the target company's privilege rights in pre-closing communications to a sell-side group or representative or otherwise prevent such rights from flowing to the buyer, these suggestions may strengthen the selling stockholders' efforts in attempting to limit the buyer's ability to access such communications or to use them against the sellers' interests.⁴

Footnotes

¹ In its opinion, the court noted that the sellers made no attempt to address this privilege issue in their contractual agreement. It therefore concluded that there was no possibility of overriding the clear statutory language of Section 259. It is not clear, however, whether the court was saying that contractual language specifying a different outcome would necessarily be honored or whether it was simply noting that this was an issue that it did not need to consider based on the facts of this case.

² There is some precedent for contract language alone not necessarily being dispositive of the outcome of who is the proper holder of the privilege. In *American International Specialty Lines Insurance Co. v. NWI-I, Inc.*, 240 F.R.D. 401 (N.D. Ill. 2007), the court ruled that contract language seeking to allocate the privilege to a party might not be honored if that party is not deemed a successor to the entity that previously held the privilege.

³ The parties could also consider destroying all such communications, but that could create a host of additional risks and issues for the law firm and the target entity.

⁴ The issues addressed in this article raise new and complex challenges that require sophisticated legal analysis on each transaction. Prior to entering into any such transaction, you should consult with legal counsel. Nothing in this article is, or should be construed as, legal advice.

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