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MERGER AGREEMENTS

Changes in Control: Preserving the Privilege in M&A Transactions

By Jaculin Aaron

One topic that is often inadvertently ignored (or not addressed) by transactional lawyers is the preservation of the attorney-client privilege in matters relating to a divested subsidiary or division following a sale or merger. Mergers and acquisitions lawyers have an opportunity to use their drafting pens to create contract terms that could help protect their clients in this context. This article analyzes the existing law on control of the attorney-client privilege following a change in ownership of a company and how these rules might be varied by contract. In addition, this article will address the attorney conflict of interest issues that may arise when a lawyer represents both a parent and a subsidiary that is later divested and how those issues might be addressed in the merger or sale agreement. Specific examples of contract language that could be used are included as well.

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The author wishes to thank Shearman & Sterling associates Brian Calandra and Nicole Gragg for their assistance in the preparation of this article.

Sale or Merger of a Subsidiary–Scope of the Privilege That Remains with the Subsidiary

The leading case on control of the attorney-client privilege following a change in corporate control is the New York Court of Appeals' decision in *Tekni-Plex, Inc. v. Meyner & Landis*.[1] In *Tekni-Plex*, a sole shareholder sold a corporation pursuant to a merger agreement that included a warranty of compliance with environmental laws and a promise to indemnify the buyer for losses incurred as a result of misrepresentation or breach of those warranties.[2] The same outside counsel represented both the seller and the target company in the merger transaction, and had represented the target company in a variety of legal matters prior to the merger, including environmental compliance.[3] When the buyer discovered violations of environmental law by the target, it sued the selling shareholder for breach of warranty and misrepresentation, moved to disqualify the attorney from representing the seller in the arbitration, and asserted privilege as to all communications on the environmental compliance matters between the target company and the attorney.[4]

With regard to the motion to disqualify the shareholder's counsel, the court agreed with the buyer. It held that the lawyer could not represent the sole shareholder in an action against his former corporate client (the target) in a matter substantially related to that representation.[5] The court held that ''when ownership of a corporation changes hands, whether the attorney-client relationship transfers as well to the new owners turns on the practical consequences rather than the formalities of the particular transaction.''[6] Because the buyer had continued the business operations of the old corporation substantially unchanged, the merged corporation

[1] 674 N.E.2d 663 (1996).
[2] *Id.* at 665-66.
[3] *Id.*
[4] *Id.*
[5] *Id.* at 669.
[6] *Id.* at 668.

 ISSN 1098-4720

retained the rights and privileges arising from the former attorney-client relationship with the lawyer.[7] Although the court focused on the ''practical consequences'' in deciding the case, the same result would have been reached by considering the ''formalities,'' since the merger subsidiary created for the transaction likely would have succeeded to the target company's rights and privileges in any event.

The court's focus on practical consequences did make a difference, however, in its determination as to who controlled the privilege for specific categories of communications. The court separated the communications into two categories: general business communications and communications relating to the merger negotiations.[8] The court held that the buyer had succeeded to the control of target's privilege regarding general business communications because it ''continued the business operations of the pre-merger entity.''[9] Because the factual record did not support the seller's assertion that he was a co-client of the target with respect to environmental compliance matters, the court held that the lawyer could not disclose to the seller confidential communications and information relating to his representation of the target in those matters.[10]

In contrast, the court held that the buyer had not succeeded to the privilege for communications related to the merger transaction.[11] The court found that the structure of the transaction and the language in the merger agreement aligned the seller and the ''old'' corporation against the buyer and the ''new'' corporation.[12] The court in particular referred to the seller's indemnification of the buyer for misrepresentations made by the ''old'' corporation. As a result, the court concluded, the seller would retain the privilege for attorney-client communications related to the merger transaction in the event of a dispute.[13] The court noted that holding otherwise would mean that the seller would have to defend the transaction without the benefit of the legal advice he received when negotiating the transaction and that future sellers could become reluctant to communicate openly with counsel knowing that ''privileged communications . . . concerning the negotiations might be available to the buyer for use against the old corporation in any ensuing litigation.''[14]

Other courts have reached different results about the control of the privilege following a change in control of a corporation. In *Bass Public Ltd. Company v. Promus Companies Inc.*,[15] a buyer sued the seller for misrepresentation and fraud, and the seller attempted to assert privilege against the buyer, including with respect to the merger transaction itself. The court rejected the seller's privilege claim and held that the seller had no expectation of confidentiality because it and the target company had shared a joint attorney-client privilege that had then come under the control of the buyer after the sale.[16] *Polycast Technology Corporation v. Uniroyal, Inc.*,[17] and *Medcom Holding Company v. Baxter Travenol Laboratories, Inc.*,[18] also held that where counsel jointly represented a seller and a target in a merger transaction, the seller could not assert the privilege against the buyer even as to privileged communications concerning the merger.

In *In re Teleglobe Communications Corp.*, the Third Circuit held that in cases where there was a joint representation of the parent and subsidiary, following a change in control neither party could unilaterally waive the privilege (except for communications concerning only itself). In addition, the privilege could not be asserted by either party against the other if they later became adverse.[19] The court observed that a joint representation between a parent and subsidiary is likely to be narrow in scope, but that counsel for the parent should be careful to ensure that the joint representation does not extend further than is necessary. As the court observed, ''it is important for in-house counsel in the first instance to be clear about the scope of parent-subsidiary joint representations. By properly defining the scope, they can leave themselves free to counsel the parent *alone* on the substance and ramifications of important transactions without risking giving up the privilege in subsequent adverse litigation.''[20]

Asset Sales—Splitting the Privilege

When a transaction involves a sale of assets rather than the sale of a corporate entity, it is not clear whether and to what extent the buyer succeeds to the privilege relating to the assets or the business made up of the assets. In *Soverain Software LLC v. Gap, Inc.*,[21] the court held that the buyer of the assets did succeed to the privilege. In that case, the buyer of a division of a bankrupt entity sued a third party alleging infringement of a patent. The defendant subpoenaed communications related to the patent, arguing that because the buyer had not purchased the actual entity (the holder of the privilege) out of bankruptcy, it could not invoke the attorney-client privilege.[22] The court distinguished the case from those involving ''a mere transfer of assets'' and found that the buyer succeeded to the privilege because it continued to operate the business.[23] In *Postorivo v. AG Paintball Holdings, Inc.*,[24] the Delaware Court of Chancery, applying New York law, likewise acknowledged that a corporation's privilege could be ''split,'' with the buyer of certain assets succeeding to the privilege with respect to those assets but not those retained by the seller.[25] The court concluded that thus ''splitting'' the privilege was acceptable for three reasons. First, because the language of the asset purchase agreement granted the parent extensive rights in the assets and liabilities retained, the court determined that it was appropriate to defer to the intent of the parties in a

[7] *Id*. at 669.
[8] *Id*. at 670.
[9] *Id*. at 671.
[10] *Id*. at 670-71.
[11] *Id.* at 671.
[12] *Id.* at 672.
[13] *Id.*
[14] *Id.* at 672.
[15] 868 F. Supp. 615, 616-19 (S.D.N.Y. 1994).
[16] *Id*. at 620-21.
[17] 125 F.R.D. 47, 49 (S.D.N.Y. 1989).
[18] 689 F. Supp. 841, 842 (N.D. Ill. 1988).
[19] 493 F.3d 345, 366-68, 379 (3d Cir. 2007); *see also* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 75 (2000).
[20] *Id*. at 383.
[21] 340 F. Supp. 2d 760, 763 (E.D. Tex. 2004).
[22] *Id.*
[23] *Id*.
[24] 2008 BL 24285 (Del. Ch. Feb. 7, 2008).
[25] *Id.* at *1-2.

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freely negotiated transaction.[26] Second, the court determined that holding otherwise would lead to an impractical result: the parent seller would have to prosecute litigation or defend a retained liability without access to the prior privileged communications with its attorney.[27] Third, the case did not involve the potential division of privilege among multiple successors,[28] which has been a concern of courts holding that a buyer of assets does not succeed to the privilege related to those assets. In *Zenith Electronics Corp. v. WH-TV Broadcasting Corp.*,[29] for example, a buyer purchased certain assets from the seller and then in subsequent litigation sought to assert the attorney-client privilege as to communications relating to those assets. The court held that ''the mere transfer of some assets . . . does not transfer the attorney-client privilege.''[30] It came to this conclusion despite the existence of specific language in the asset purchase agreement purporting to transfer the privilege at issue.[31] The same result was reached in *American International Specialty Lines Insurance Company v. NWI-I, Inc.*,[32] where the court held that ''[a]bsent control of the corporation, . . . the attorney-client privilege does not pass to a successor entity, even with respect to the assets that were transferred to that successor.''[33]

Preserving the Privilege Following a Change of Control—Contractual Provisions. Given the lack of clarity and uniformity in the law, parties to a change in control transaction may wish to include in their sale or merger agreement specific terms that govern the control of the attorney-client privilege. A seller may want to ensure that it retains complete and unilateral control over the attorney-client privilege it otherwise shared with the subsidiary, certainly with respect to the sale or merger transaction itself and possibly with respect to other sensitive matters as well. While *Tekni-Plex* provides some assurance on that score with respect to the privileged materials related to the merger or sale transaction[34], it provides none at all with respect to pre-transaction privileged materials relating to the business of the subsidiary.

Authority exists to support the enforceability of agreements with respect to the control of the attorney-client privilege following a change in control. With respect to the attorney-client privilege arising in a joint representation, the Restatement of the Law Governing Lawyers notes that it is permissible for co-clients to agree in advance to shield information from one another in subsequent adverse litigation.[35] The court in *Bass* appeared to endorse the validity of agreements governing the control of the privilege following a change in corporate control when it observed that ''if the parties had intended to exclude the subpoenaed documents from the purview of the Merger Agreement, it could have accomplished this goal by drafting the document accordingly.''[36] *Tekni-Plex* implicitly supports the proposition that the parties can determine who controls the privilege by their contractual arrangements.

Some courts, primarily in the bankruptcy context, have refused to enforce agreements that seek to reserve control of the privilege to a parent company. In *In re Mirant Corporation*,[37] a parent spun off a subsidiary that was represented by the same counsel as the parent. After filing for bankruptcy, the subsidiary sought privileged communications that had arisen from the joint representation.[38] The parent asserted privilege based on a clause in an engagement letter with the attorneys suggesting that the parent had the right to invoke the privilege against the subsidiary.[39] The court construed the language at issue as not constituting such a reservation of privilege rights and then held that such an agreement would have been void as against public policy in any event.[40]

Examples of Contract Language

Set forth below are examples of contract language that might be used in a merger or sale agreement to reserve to the seller control of the attorney-client privilege for matters related to the divested subsidiary or assets. While there is no assurance that these provisions would be enforceable, they could be useful in helping the parent to retain control of the privilege for sensitive legal issues, particularly with respect to the negotiation of the sale or merger transaction itself. Also set forth below are examples of contract terms that would provide for the waiver of potential conflicts of interest for counsel that jointly represented the parent and the subsidiary prior to the transaction.

As used in the examples below, ''Seller'' refers to the parent company or selling shareholder; ''Company'' refers to the company owned by the Seller and being sold, spun-off, or merged; ''Business'' refers to the assets sold in an asset sale; ''Buyer'' refers to the entity purchasing the Company or controlling the surviving entity in the merger; ''Law Firm'' refers to outside counsel representing the Seller and/or the Company; ''In-House Counsel'' refers to in-house lawyers representing the Seller and/or the Company; and the ''Parties'' are the parties to the merger or sale agreement.

Provisions Regarding Control of the Privilege

No Joint Privilege

Buyer and Company acknowledge that Law Firm and In-House Counsel represented only the Seller and not the Company and that any advice given to or communi-

[26] *Id.*
[27] *Id.*
[28] *Id.* at *19.
[29] 2003 BL 2571, at *2 (N.D. Ill. Aug. 7, 2003).
[30] *Id.*
[31] *Id* at *3.
[32] 240 F.R.D. 401 (N.D. Ill. 2007).
[33] *Id.* at 407.
[34] It is not certain that *Tekni-Plex* established a rule that can be relied on generally because it is not clear to what extent the court's reasoning depended on specific provisions of the sale agreement at issue in that case.
[35] RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 75 cmt. d (2000).
[36] 868 F. Supp. at 620 -21.
[37] 326 B.R. 646, 647 (Bankr. N.D. Tex. 2005).
[38] *Id.* at 648.
[39] *Id.*
[40] *Id.* at 652. *See also In re Ginn-LA St. Lucie Ltd., LLP*, 439 B.R. 801, 803 (Bankr. S.D. Fla. 2010); *Zenith Electronics Corp.*, 2003 BL 2571, at *2 (N.D. Ill. Aug. 7, 2003) (''[Buyer's] position would allow anyone to evade waiver of the privilege, despite the transfer of privileged documents to a third party, merely by agreeing to transfer the privilege and accepting consideration for it.'').

cation with the Seller by Law Firm or In-House Counsel is not and shall not be subject to any joint privilege and is and shall be owned solely by the Seller.

Comment: The purpose of this clause is to help ensure that the Seller's separate legal counsel is not also considered counsel for the Company, such that the Company would have joint control over the privilege and could use the privileged materials against the Seller.

Seller Controls Privilege (As to Transaction)

It is acknowledged by each of the Parties that Law Firm and In-House Counsel (together, ''Counsel'') have represented the Seller and the Company in connection with the transactions contemplated by this Agreement. Buyer and the Company agree that any attorney-client privilege, attorney work-product protection, and expectation of client confidence attaching as a result of Counsel's representation of the Company or Seller in connection with the transactions contemplated by this Agreement, and all information and documents covered by such privilege or protection, shall belong to and be controlled by the Seller and may be waived only by Seller, and not the Company, and shall not pass to or be claimed or used by Buyer or the Company, except as provided in section __ [asserting privilege as against third parties].

Comment: This provision is intended to ensure the application of the holding of *Tekni-Plex*, so that that the Seller retains sole control over the privileged materials relating to the merger or sale transaction, even if there was a joint representation of the Seller and the Company. There may be practical limitations on the extent to which the Seller can protect privileged materials, given that privileged documents and personnel who had access to privileged communications may remain with the Company after the sale. It may be prudent for the Seller to ensure that such privileged documents are removed from the Company prior to the closing, to the extent that is consistent with any litigation preservation or other obligations to which the Company may be subject.[41]

Seller Controls Privilege (Broad)

The attorney-client privilege, attorney work-product protection, and expectation of client confidence arising from legal counsel's representation of the Company prior to the Effective Time, and all information and documents covered by such privilege or protection, shall belong to and be controlled by the Seller and may be waived only by Seller, and not the Company, and shall not pass to or be claimed or used by Buyer or the Company, except as provided in section __ [asserting privilege as against third parties].

Seller Controls Privilege (As to Indemnified Matters)

The attorney-client privilege, attorney work-product protection, and expectation of client confidence arising from legal counsel's representation of the Company prior to the Effective Time concerning any subject matter with respect to which the Seller has or may have an indemnification obligation hereunder, and all information and documents covered by such privilege or protection, shall belong to and be controlled by the Seller and waived only by Seller, and not the Company, and shall not pass to or be claimed or used by Buyer or the Company, except as provided in section __ [asserting privilege as against third parties].

Comment: These two provisions are intended to protect pre-merger privileged materials arising out of the business operations of the Company and/or the Parent. The broad provision, which is not restricted by subject-matter, might very well be resisted by the Buyer. The narrower provision, relating to matters as to which the Seller has an indemnification obligation, might be difficult to apply in practice since it may not always be clear what materials it would cover. A third alternative would be a provision that reserved to the Seller the attorney-client privilege related to identified sensitive matters that are of particular concern to the Seller.

Privileged Materials Excluded from Sale of Assets

Excluded Assets include: (i) any attorney-client privilege and attorney work-product protection of Seller or associated with the Business as a result of legal counsel representing Seller or the Business, including in connection with the transactions contemplated by the Agreement; (ii) all documents maintained by legal counsel as a result of representation of the Seller or the Business; (iii) all documents subject to the attorney-client privilege and work-product protection described in subsection (i); and (iv) all documents maintained by the Seller in connection with the transactions contemplated by this Agreement.

Comment: The provision is intended to help ensure that the attorney-client privilege related to assets sold would remain with the Seller, even if the assets constituted an operating line of business.

Assert Privilege Against Third Parties

In the event that a dispute arises between Buyer or the Company and a third party other than the Seller, the Company shall assert the attorney-client privilege on behalf of the Seller to prevent disclosure of privileged materials to such third party; provided, however, that such privilege may be waived only with the prior written consent of the Seller.

Comment: This provision imposes an obligation upon the Buyer and Company not to disclose privileged materials to a third party and to assert the privilege on behalf of the Seller.

Conflict Waivers

Buyer and Company Waive Conflict (in Disputes Related to Transaction)

Buyer and the Company agree that, notwithstanding any current or prior representation of the Company by Law Firm or In-House Counsel (together, ''Counsel''), Counsel shall be allowed to represent the Seller in any existing or future matters or disputes adverse to Buyer or the Company relating to this Agreement or the transactions contemplated hereby. Buyer and the Company hereby waive any conflicts that may arise in connection with such representation. Buyer and the Company agree that Counsel may represent the Seller in such a matter or dispute, before or after Closing, even though the interests of the Seller may be directly adverse to Buyer or the Company, and even though Counsel may be currently representing Buyer or the Company, or may have previously represented the Company in a matter substantially related to such matter or dispute.

Comment: A Seller may wish to continue to use an outside Law Firm and In-House Counsel that have also represented the Company, which might give rise to an

[41] In *Postorivo*, the Delaware Court of Chancery concluded that there was no inadvertent waiver of the privilege as a result of leaving privileged materials with the business that had been sold, specifically on the business' computers and servers. 2008 BL 24285, at *8 W n.13.

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actual or potential conflict of interest. Under New York ethics rules, the enforceability of an advance waiver of such a conflict requires that: (i) the lawyer appropriately disclose the implications, advantages, and risks involved; (ii) the client can make an informed decision whether to consent; (iii) a disinterested lawyer would believe that the lawyer can competently represent the interests of all affected clients; and (iv) the waiver be in writing.[42]

Buyer and Company Waive Conflict (Broad)

Buyer acknowledges that Law Firm and In-House Counsel (together, ''Counsel'') have acted as counsel for Seller and that, in the event of any post-Closing matters or disputes between the parties hereto, Seller reasonably anticipates that Counsel will represent it in such matters or disputes. Buyer and the Company consent to Counsel's representation of Seller in any post-Closing matter or dispute in which the interests of Buyer or the Company, on the one hand, and Seller, on the other hand, are adverse, whether or not such matter or dispute is substantially related to one in which Counsel may have previously advised the Company.

Comment: Factors that may be relevant in determining enforceability of an advance conflict waiver in the M&A context include: (i) the sophistication of the Buyer and its separate counsel; (ii) that the waiver was agreed to in an arms-length transaction; (iii) that the Buyer has also agreed that the attorney-client privilege and secrets will be retained by Seller; (iv) that the Parent knows or had access to privileged information and secrets of the Company; and (v) the legal principle that a solvent wholly-owned subsidiary may be managed for the benefit of the parent.[43]

Consent to Disclosure to Seller

Buyer and the Company consent to the disclosure by Law Firm and In-House Counsel (together, ''Counsel'') to Seller of any information learned by Counsel in the course of their representation of the Company prior to Closing, whether or not such information is subject to the attorney-client privilege of the Company and/or Counsel's duty of confidentiality as to the Company and whether or not such disclosure is made before or after the Closing.

Comment: This provision is intended to reinforce the advance conflict waiver and to help ensure that Seller's Counsel is not disqualified in any dispute with the Company or the Buyer, notwithstanding Counsel's prior representation of the Company.

Understand Waiver

Buyer and the Company hereby acknowledge that each of them have discussed with [Buyer's Counsel] [and Law Firm and In-House Counsel] and obtained adequate information concerning the relevant implications, advantages, and risks of, and reasonable available alternatives to, the waivers, permissions and other provisions of this Agreement.

Comment: The Seller and Counsel should also consider a side letter or agreement with a more detailed discussion of the implications and risks of waiver.[44]

Counsel Intended Beneficiaries

This Section is for the benefit of the Seller, Law Firm, and In-House Counsel, and such Persons are intended third-party beneficiaries of this Section. This Section shall be irrevocable, and no term of this Section may be amended, waived or modified, without the prior written consent of Seller, Law Firm, and In-House Counsel.

Comment: This provision is intended to help clarify and ensure that Counsel is protected by the conflict waiver.

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[42] *See* Ass'n of the Bar of the City of New York Committee on Professional and Judicial Ethics, Formal Opinion 2006-1.

[43] *See, e.g., Trenwick America Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 200 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

[44] *See* Ass'n of the Bar of the City of New York Committee on Professional and Judicial Ethics, Formal Opinion 2006-1.