HOLD ON TO THAT PRIVILEGE! THE TRANSFER OF PRIVILEGE WITH THE SALE OF A CORPORATE SUBSIDIARY

The sale of your corporate subsidiary has just closed, and now it's time to congratulate one another and take a few days off. The phone rings. It's your outside counsel. He has just received a call from the general counsel of the acquiring company, who wants to talk to his law firm, which represented both your company and the subsidiary, about some "contingent liabilities" that the buyer has allegedly just found. Wait a second—she can't talk to *your* outside counsel, because that would violate the privilege. You call her and ask her what she thinks she's doing. She says she merely wants to talk to *former* counsel to the corporate entity that her company has just purchased on the matters as to which the law firm represented the subsidiary (not everything it did for the parent). By the way, she may have a few questions for you because your office performed legal services for both companies. Is she off her rocker? As it happens, no, she is not crazy. You failed to see the transfer of the privilege, and now you will pay for that failure.

By John K. Villa

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In today's fast-moving corporate world, it seems as if corporate subsidiaries are bought and sold like properties on a Monopoly board. Unfortunately, the rules of attorney-client privilege have not, in some lawyers' estimation, kept up with corporate realities. A prime example of this phenomenon is the problem that can occur if corporate lawyers fail to anticipate the general rule that the attorney-client privilege transfers with the other assets of a corporate entity *unless the parties otherwise agree*. The failure to reach agreement can prove to be a costly error, especially if the acquiring entity uses this tactic to develop adverse information regarding the issues that were involved in the sale transaction itself.

By way of background, it is fair to say that the ethics and privilege rules that determine when a parent and its subsidiary are treated as a single entity are still developing. Many courts, however, have found that a parent corporation and its wholly owned subsidiary share a common interest, and for this reason, they are considered the client of corporate counsel for purposes of the attorney-client privilege.[1] In other situations, the counsel explicitly represents both the parent and the subsidiary on some discrete issues, albeit not on all matters.[2] Because each corporation is a client, the privilege has been characterized as a joint privilege[3] that either entity may assert[4] or waive[5] against a third party seeking the disclosure of confidential communications. Because, however, counsel for the parent is deemed an agent of the subsidiary and vice versa,[6] neither entity may raise the privilege as a bar against the other.[7]

If the stock of the subsidiary is sold to a third party, the right to assert the attorney-client privilege is subject to the control of the transferred corporation and passes to new management upon a change in the control of the corporation.[8] The right to assert or waive the privilege on behalf of the subsidiary likewise passes to the new owners.[9] Essentially, the purchasing corporation, or newly created entity into which the transferred subsidiary may have merged, "acquires" the former subsidiary's share of the joint

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John K. Villa, "Hold on to That Privilege! The Transfer of Privilege with the Sale of a Corporate Subsidiary," *ACCA Docket* 19, no. 10 (2001): 100–102.

privilege,[10] which it may unilaterally waive at its discretion.[11]

This rule has its greatest effect in cases in which allegations of breach of contract, fraud, or other misconduct in connection with the sale of a subsidiary arise subsequent to the sale: what had been protected communications during the course of negotiations between the parent corporation, its subsidiary, and their joint lawyer may now be subject to disclosure upon the demand of the adverse new owners of the subsidiary.[12] Although both the former parent corporation and the subsidiary "are entitled to assert the attorney-client privilege with respect to communications made on their behalf, either may waive it[,]" and the latter is now at the discretion of the new owner.[13] Such a consequence may well be very damaging to the interests of the parent corporation, but prudent action before the sale may help avoid or at least minimize any resulting damage.

One approach is to include a provision in the sales agreement that states that the parent corporation does not relinquish its control over the attorney-client privilege.[14] It has been held that providing in the agreement that the corporation retains "all its rights [and] privileges" following the sale as existed before the sale may be sufficient to support the finding that the corporation intended to retain control over the exercise of the privilege. A more detailed agreement or provision that allows the new subsidiary to obtain information from joint counsel on all matters other than those involving the sale transaction may also be an appropriate division of the privilege.

Even perfect foresight, however, may not prevent this problem. The strategic and planning dilemma facing corporate counsel is that, at the outset of sale negotiations, one cannot predict with assurance precisely which terms the purchaser will ultimately agree to. If the financial terms are sufficiently attractive or if the business consequences of failing to sell are unbearably bleak, then seller's counsel may not be able to insist on a provision that retains the privilege (or any part of it) for the seller. Arguing that the provision is necessary to prevent the purchaser from inquiring into fraud-in-the-transaction claims will surely chill negotiations.

The need for taking precautions against compelled disclosures of confidential communications is also important in cases in which a subsidiary separates from the parent corporation and assumes an independent corporate identity. Although the subsidiary may be precluded from asserting the attorney-client privilege against its parent as to matters in which they may share a joint privilege,[15] its authority to waive the privilege with respect to these matters in any subsequent investigation or litigation[16] could likewise prove harmful to its former parent.

From this point on . . .
Explore information related to this topic.

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- ACCA's database of case law related to the application of the attorney-client privilege to in-house counsel is available on ACCA Online℠ at www.acca.com/vl/caselaw.html.
- ACCA's InfoPAK on the attorney-client privilege is available on ACCA Online℠ at www.acca.com/infopaks/attclient.html.

What have we learned from this discussion, and what steps can one take?

- In an ideal world, with unlimited funds for counsel, each separate corporation could always be represented separately, but this solution is impractical and wasteful.
- When approaching the sale of a significant subsidiary, however, the selling corporation may want to retain new and separate counsel to represent the subsidiary in the transaction while using the parent's traditional counsel to handle the sale for the parent.
- The parties should explicitly agree, in the initial term sheet if possible, to the handling of the privilege and the fact that the subsidiary will have no right to any information arising from the sale transaction. This term must obviously be included in the final agreement, as well.
- To the extent possible, lawyers who had jointly represented both the parent and the subsidiary before the sale should attempt to segregate their files to facilitate any postsale inquiry by the subsidiary.

NOTES

1. In re Southern Air Transport, Inc., 255 B.R. 706, 711 (S.D. Ohio 2000); Glidden Co. v. Jandernoa, 173 F.R.D. 459, 472 (W.D. Mich. 1997); *see* United States v. AT&T, 86 F.R.D. 603, 616–617 (D.D.C. 1979) (noting that the corporate client consists of the parent corporation, its wholly owned subsidiaries, and, in some cases, its partially owned subsidiaries).
2. A good example of this rule is the dispute between DuPont and Conoco. *See* Charles F. Richards Jr. and Thad J. Bracegirdle, *Attorney-Client Privilege: The Role of Counsel in Parent-Subsidiary Transactions*, CORP. LAW DAILY (May 18, 2001) (discussing oral ruling in E.I. Du Pont de Nemours & Co. v. Conoco, Inc., C.A. No. 17686 (Del. Ch. Feb. 6, 2001), involving the defendant's break-off from the plaintiff, wherein the court held that there was no evidence that parent's outside counsel had jointly represented subsidiary with respect to tax-sharing agreement, in which their interests were adverse and for which subsidiary had been represented by separate counsel with respect to separation agreement).
3. Bass Public Ltd. Co. v. Promus Companies, Inc., 868 F. Supp. 615, 620 (S.D.N.Y. 1994); Polycast Technology Corp. v. Uniroyal, Inc., 125 F.R.D. 47, 49 (S.D.N.Y. 1989); Medcom Holding Co. v. Baxter Travenol Lab., Inc., 689 F. Supp. 841, 844 (N.D. Ill. 1988).
4. In re Grand Jury Subpoenas, 89-3 and 89-4, 902 F.2d 244, 249 (4th Cir. 1990).
5. Bass Public Ltd. Co. v. Promus Companies, Inc., 868 F. Supp. at 620; Polycast Technology Corp. v. Uniroyal, Inc., 125 F.R.D. at 49.
6. For purpose of the privilege, when a parent corporation owns a controlling interest in a corporate subsidiary, the parent corporation's agents who are responsible for legal matters of the subsidiary are considered agents of the subsidiary. The subsidiary corporation's agents who are responsible for affairs of the parent are also considered agents of the parent for the purpose of the privilege. *Restatement (Third) of The Law Governing Lawyers* § 73, cmt. d (2000).
7. In re Southern Air Transport, Inc., 255 B.R. at 712; Glidden Co. v. Jandernoa, 173 F.R.D. at 472.
8. Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 349, 105 S. Ct. 1986, 85 L. Ed. 2d 372 (1985); *see Restatement (Third) of The Law Governing Lawyers, supra,* § 73 at cmt. k; *cf.* Pilates, Inc. v. Georgetown Bodyworks Deep Muscle Massage Centers, Inc., 201 F.R.D. 261 (D.D.C. 2000) (plaintiff corporation was not a successor-in-interest of defendant corporation for purposes of assertion of attorney-client privilege in case in which plaintiff had acquired only trademarks from defendant, but had not acquired any stock or any other financial assets).
9. Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. at 349; Bass Public Ltd. Co. v. Promus Companies, Inc., 868 F. Supp. at 619; Polycast Technology Corp. v. Uniroyal, Inc., 125 F.R.D. at 49; Medcom Holding Co. v. Baxter Travenol Lab., Inc., 689 F. Supp. at 844; *see also* In re Grand Jury Subpoenas, 902 F.2d at 248 (when a subsidiary becomes an independent corporate entity with the consent of the parent, the new entity has the authority to waive the privilege).
10. Polycast Technology Corp. v. Uniroyal, Inc., 125 F.R.D.at 49.
11. Bass Public Ltd. Co. v. Promus Companies, Inc., 868 F. Supp. at 621.
12. *See* Polycast Technology Corp. v. Uniroyal, Inc., 125 F.R.D. at 51 (in action by buyer of subsidiary against former parent corporation for having allegedly supplied misleading financial data, court granted buyer's motion to compel former parent corporation to produce notes taken by officer of former subsidiary regarding advice given by parent's in-house counsel as to officer's duty to disclose business data to buyer); Medcom Holding Co. v. Baxter Travenol Lab., Inc., 689 F. Supp. at 844 (in action by buyer of subsidiary against former parent corporation, court compelled parent to produce documents containing confidential communications generated during presale negotiations between parent corporation's in-house counsel and officers of its subsidiary relating to sale of the latter).
13. Medcom Holding Co. v. Baxter Travenol Lab., Inc., 689 F. Supp. at 845.
14. *See* Bass Public Ltd. Co. v. Promus Companies, Inc., 868 F. Supp. at 620 (recognizing that such a provision in a merger agreement was indicative of an intent that acquired corporation continue as joint holder of attorney-client privilege with former subsidiary and thus could waive the privilege for the benefit of its new corporate parent).
15. Glidden Co. v. Jandernoa, 173 F.R.D. 459, 472 (W.D. Mich. 1997).
16. *See* In re Grand Jury Subpoenas, 902 F.2d at 248.