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Post-Transaction Privilege Lessons From Del. M&A Opinion

By **Sawyer Duncan** (June 16, 2020, 5:04 PM EDT)


Sawyer Duncan

In a letter opinion recently published by Vice Chancellor Morgan Zurn, the Delaware Court of Chancery provided helpful guidance on a frequently debated deal point in M&A transactions.

The opinion in DLO Enterprises Inc. v. Innovative Chemical Products Group LLC[1] articulates for the first time Delaware's default position on the passing of ownership of a seller's privileged, preclosing communications with its counsel following the closing of an asset purchase transaction.

This article will explore questions of post-closing ownership of privileged communications between attorney and client and will close with some practical guidance for transactional lawyers when addressing these issues.

Background

Buyers and sellers of businesses confide in their advisers as they complete M&A deals. Each side shares proprietary information with their attorneys and other advisers as they develop a strategy and competitively negotiate for favorable terms and conditions in the definitive contract that memorializes their business deal.

During the negotiation process, information that clients share in confidence with their lawyers becomes protected by attorney-client privilege. Once the buyer assumes ownership and control of a purchased business following the closing, it sometimes discovers legacy liabilities of the purchased business were failed to be detected during due diligence.

This can give rise to post-closing legal disputes regarding indemnification and other contract-related causes of action. In pursuing redress, a buyer may desire to seek access to information regarding the legacy liabilities of the target and the extent to which such risks may have been known, but not disclosed, by the seller prior to the closing.

To the extent a buyer can establish a seller's knowledge or awareness of certain undisclosed liabilities, a buyer can more likely assert common law claims for fraud or willful misrepresentation, which often permit the buyer to pursue a larger recovery by circumventing liability limitations on contractual indemnification, such as escrows, baskets, caps and shorter survival periods.

One way that buyers often seek to establish evidence for these claims is by investigating preclosing communications of the sellers with their advisors, on the theory that if a seller knew about particular risks or liabilities and intended to hide them in a dishonest manner, the seller may also have discussed them with those advisors under the veil of privilege.

Sellers' internal discussions with their lawyers often span a variety of sensitive topics, such as those regarding valuation, employee-related affairs, performance projections, competing strategic alternatives, and others, most of which may not be directly relevant to a buyer's post-closing claim.

From a seller's perspective, attorney-client privilege encourages candor and should be respected, such that rightfully privileged communications should not become discoverable against the seller after closing.

To preempt the contention that arises in these situations, sophisticated parties bargain and contract for deal terms that clarify who owns the privilege attaching to the seller's preclosing, deal-related communications with its lawyers.

While parties are free to create bespoke contract provisions that reallocate the ownership of the privilege and specify the circumstances under which it might be waived following the closing of an M&A transaction, Delaware has provided default positions that would apply in circumstances where the parties' transaction agreement is silent in this regard.

In the context of a merger, which is a statutory technique effectuated pursuant to state law, the default position in Delaware as to post-closing ownership of privileged, premerger communications under has been made clear by former Chancellor Leo Strine in 2013.

In an opinion referred to in the deal-making community as Great Hill, the Delaware Chancery Court concluded that, absent an express agreement to the contrary, premerger privileges, including the attorney-client privilege, pass to the surviving corporation in a merger by operation of law.[2]

This holding made good sense in light of the relevant Delaware General Corporation Law statute, which provides that, following a merger transaction, "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."[3]

The Great Hill opinion noted that parties can use their contractual freedom to opt otherwise, and tailored provisions providing for seller retention of privileged premerger communications have become a staple of sophisticated sell-side M&A lawyering today.[4]

Asset purchase transactions, however, are quite different in form and substance from statutory mergers. Until now, Delaware law has not enunciated a default rule as to whether the attorney-client privilege of preclosing communications is passed to a purchaser of assets by operation of law.

The DLO Enterprises opinion clarifies that "privilege regarding an asset purchase agreement and associated negotiations does not pass to the purchaser by the default operation of any law, but rather, remains with the seller unless the buyer contracts for something different."

The Chancery Court's Analysis

In the case at hand, Innovative Chemical Products Group LLC and an affiliate purchased substantially all of the assets of Arizona Polymer Flooring Inc. pursuant to an asset purchase agreement in January 2018. Thereafter, Arizona Polymer Flooring Inc. changed its corporate name to DLO Enterprises Inc.

After closing, the purchased business allegedly suffered from product defects that are presently the subject of an ongoing dispute between the parties. Alleging that the seller knew about the defects and made knowing misrepresentations about them, the buyer sought to compel production of various documents reflecting privileged deal and negotiation-related communications between the seller and its counsel in the transaction.

The communications consist of two batches of information: The first batch is a group of documents collected by the seller and produced in redacted form, and the second batch is comprised of documents in the buyer's possession because they were left in email accounts that were used by the seller prior to closing that were transferred to the buyer after the closing.

As such, the DLO Enterprises opinion addresses two different classes of attorney-client privilege waiver doctrines. First, the buyer argued that any attorney-client privilege attaching to the category 1 documents was passed to it by operation of Delaware law following the closing and that the buyer purchased the right to waive that privilege over the category 1 documents pursuant to the provisions of the asset purchase agreement.

Then, with respect to the category 2 documents, the buyer argued that the seller waived any privilege to them upon transferring the email accounts in which they were contained to the buyer and that seller did not reasonably have an expectation of privacy when using the transferred email accounts. The sellers contended that both categories of the communications remain privileged.

First, Vice Chancellor Zurn addressed the category 1 documents, quickly identifying the meaningful distinction between the statutory nature of a merger and the contractual nature of a private asset purchase transaction.

Asset purchase contracts specifically enumerate the assets and liabilities being transferred or retained, as opposed to a merger whereby the surviving entity automatically succeeds to all of the property, rights, privileges, powers and franchises of its counterparty.

Following the sale of substantially all of its assets, the seller continued to exist as a standalone entity and was not absorbed by, combined with or merged into the buyer, and the Chancery Court observed that the seller still holds some unsold assets "together with related privileges."

Because both the Buyer and the Seller continue to exist with independent rights that are adverse "to each other, as evidenced by the parties' present dispute regarding indemnification for the defective product line, Vice Chancellor Zurn explained that "the default permits each party to retain the privilege attached to its position in the asset purchase relationship."

The opinion goes on to emphasizes that, under Delaware law, upon the closing of an asset purchase transaction, the seller continues to own the privilege regarding preasset sale communications, unless the buyer explicitly negotiates for a waiver provision to the contrary.

Note that this is essentially the logical inverse of the default position in a merger context established by Great Hill, which places the onus on sellers to expressly contract to retain ownership of their privileged communications, lest they inure automatically to the buyer by operation of law upon closing.

But the lessons gleaned from the opinion do not end there. Because a deal lawyer's accurate implementation of the parties' bargain in an asset deal hinges on precise drafting, let us consider the operative drafting in this case as well.

The buyer pointed to a privilege waiver provision in the asset purchase agreement that was drafted by its counsel that purported to allow the buyer to waive rights over the privileges relating to the assets and assumed liabilities transferred to it under the asset purchase agreement — both of which were specifically defined terms with presumably carefully enumerated contents. But the definition of "assets" was constructed to expressly exclude an aptly titled universe of excluded assets.

And within this definition of "excluded assets" was "the [sellers'] rights under or pursuant to [the asset purchase agreement] and agreements entered into pursuant to [the asset purchase agreement]."

Because the Chancery Court understood that the seller's rights under the asset purchase agreement to be expressly excluded from those purchased by, and transferred to, the buyer upon the closing, the buyer was deemed not to have purchased documentation or privileges relating to those rights, and the privilege waiver provision in the asset purchase agreement that the buyer had hoped to rely upon was not helpful to its effort to compel discovery of the category 1 documents.

Ownership of the privilege with respect to the preclosing deal-related communications was thusly found to have remained with the seller.

With respect to the category 2 documents, which involved a different universe of information that was exchanged over a medium that eventually and validly came under the control and ownership of the buyer pursuant to the asset purchase agreement, a separate analysis was found to apply.

The DLO Enterprises opinion's analysis on the category 2 documents is primarily an exposition on confidentiality-related issues in an employee email context, and is generally less technically instructive from an M&A practitioner's perspective.

Accordingly, this article stops short of assessing the issues surrounding the privileged nature of the category 2 documents and will offer some practical advice to counsel confronting the issues of attorney-client privileged communications following the closing of an M&A transaction.

Practically Speaking

For sellers in an asset purchase transaction that wish to avoid compulsion to disclose pretransaction communications with their lawyers, the solution is simple enough: Make sure to include that the sellers' rights under the agreement, and any privileged, preclosing deal communications are expressly excluded from the assets to be transferred.

It is strongly recommended, however, for sell-side counsel to go a step further than did the asset purchase agreement in DLO Enterprises and to expressly define which of the seller's privileged, deal-related communications would be protected.

Below is one possibly suitable formulation, but take care to ensure that your approach is neatly tailored and sufficiently specific for your situational needs:

"Privileged Deal Communications" means any and all rights, privileges, and ownership of any pre-Closing communications of any kind that are subject to any attorney-client privilege, attorney work-product doctrine or other similar protection or expectation of client confidentiality for the benefit of the Seller, in any form or format whatsoever between or among the Seller's attorneys or internal counsel, on one hand, and the Seller or any of the Seller's respective directors, officers, employees or other agents or representatives, on the other hand, that relate in any respect to the negotiation, documentation and consummation of the transactions contemplated by this Agreement (or any alternative transactions similar to the transactions contemplated hereby but not consummated) or any dispute arising under this Agreement.

Transaction agreements sometimes contain 'access to information' covenants or other features that permit the buyer to make certain inquiries of the seller's books and records following a transaction.

Sell-side counsel would be wise to carefully monitor these provisions and interrelated definitions to exclude access to or availability of any such records or materials that contain or reflect privileged, deal-related communications.

Further, should a seller's law firm become an express third-party beneficiary of provisions relating to privileged deal communications? And where there are multiple, disparate asset sellers, to each of whom attorney-client privilege may individually belong, should a sole representative be designated with responsibility for adjudicating matters of privileged deal communications on behalf of the others?

As in the case of DLO Enterprises, where a buyer's interest in compelling production of privileged, preclosing communications was connected to a potentially indemnifiable loss, and particularly in more severe situations where fraud or willful misconduct is suspected, buyers in asset purchase transactions will want to move away from the default position.

For these buyers, limiting the universe of communications contemplated by the foregoing definition of "privileged deal communications" would be highly preferable for example. Further customization of the relevant provisions in an effective asset purchase agreement would also be useful.

Should a carveout be included that would allow a buyer to compel discovery in connection with a claim for fraud or under other extraordinary circumstances?

In the event that the buyer takes possession of transferred computer systems, email accounts or record-keeping databases previously used by the seller, should the asset purchase agreement specify that seller's failure to erase relevant data on those systems constitute a waiver of its privilege?

And from the sell-side perspective, should the asset purchase agreement include affirmative covenants for the buyer to abstain from digging for access to — or using metadata or other technology to recreate — privileged files once it assumes control of the purchased business assets?

Finally, there may be situations where both parties agree that the buyer should be able to receive certain protective benefits of the seller's privileged deal-related communications.

Should the buyer be allowed to assert an attorney-client privilege, which it does not own and to whom it may not have otherwise been assigned, against third parties other than the seller?

Supposing that these privileged, deal-related communications relate to business strategy, are necessary to operate the purchased business as a going concern, or are otherwise necessary to access in order to comply with applicable law or disclosure requirements, should the buyer nevertheless be afforded access to those communications for informational purposes only, with no ability to bring post-closing claims or recover damages based on those contents?

Conclusion

Buyers, sellers and their counsel should carefully consider whether the privilege attaching to the seller's preclosing deal-related communications should inure to the buyer and under what circumstances.

Since these provisions are highly bespoke, and now that substantively opposite default rules have been established under Delaware law for both mergers and asset transactions, deal lawyers should brush up their precedents accordingly.

Sawyer D. Duncan is an associate at King & Spalding LLP.

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[1] DLO Enterprises, Inc. v. Innovative Chemical Products Group, LLC (2020 WL 2844497).

[2] Great Hill Equity P'rs IV, LP v. SIG Growth Equity Fund I, LLLP, 80 A.3d 155 (Del. Ch. 2013).

[3] 8 Del. C. § 259.

[4] See S'holder Representative Servs. LLC v. RSI Holdco, 2019 WL 2290916, at *1 (Del. Ch. May 29, 2019).