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Professional Perspective

Control of the Attorney-Client Privilege Following Asset Sales

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Consider a hypothetical: two companies enter into an agreement for the buyer company to purchase most of the seller's assets. The seller will still technically exist after the transaction, but the buyer will be running the seller's former business related to the assets being purchased. The agreement between the buyer and seller does not address treatment of the attorney-client privilege related to those assets and the business being acquired, including who will control the privilege post-closing.

To what extent did the attorney-client privilege transfer from the seller to the buyer in the asset sale? This question can arise in a variety of contexts, from attorney disqualification to bankruptcy, but it most often appears where the seller and buyer of the assets are adverse to each other in subsequent litigation (often involving allegations of breach of contract, fraud, or breach of fiduciary duty) and privileged communications are placed at issue.

This article reviews the factors that affect whether the attorney-client privilege transfers after an asset sale.

The "Practical Consequences" Test

Generally, the sale of assets without more does not transfer the attorney-client relationship, and therefore, the privilege. In recent years, however, many courts addressing the privilege issue have applied a "practical consequences" test, which focuses on the actual, real-world effects of the asset sale rather than the legal formalities of how the specific transaction is structured. Under that test, the privilege will transfer to the asset buyer if "the control of the business has transferred" and "the business has been continued under the authority of the new owner." *UTStarcom, Inc. v. Starent Networks, Corp.*, No. CIV.A. 07-CV-2582, 2009 BL 423521, at *3 (N.D. Ill. Feb. 20, 2009). A transfer of the attorney-client privilege will occur under those conditions because "the practical consequence of the transaction is that control of the enterprise has passed to the new owner along with the attorney-client privilege incident to it."

Whether control of the business has transferred and whether that business has continued requires an examination of the "totality of the circumstances." When considering the totality of circumstances under the "practical consequences" test, courts often assess "the extent of the assets acquired, including whether stock was sold, whether the purchasing entity continues to sell the same product or service, whether the old customers and employees are retained, and whether the same patents and trademarks are used." *John Crane Prod. Sols., Inc. v. R2R & D, LLC*, No. 3:11-CV-3237-D, 2012 BL 119523, at *2 (N.D. Tex. May 15, 2012).

Given the scope and subjective, fact-specific nature of this analysis, different courts' applications of the test often vary and even conflict at times. As one court observed, "[t]he cases generally turn on the particular facts and circumstances of the transfers and relationships between the predecessor and successor organization. Since each indemnification is based on particularized facts, whether the various cases are consistent with each other is not readily discernible." *Parus Holdings, Inc. v. Banner & Witcoff, Ltd.*, 585 F. Supp. 2d 995, 1002 (N.D. Ill. 2008). Nevertheless, despite courts' varied rulings on the transfer of the attorney-client privilege in the context of asset sales, some common themes have emerged as to how courts apply the "practical consequences" test and what they consider.

Factors in Finding a Transfer of Attorney-Client Privilege

Change in Control and Continued Operation Post-Sale

A key question is whether there truly has been a change in control of the seller's business, and the extent to which the seller continues to operate post-sale. Courts often find the lack of any continuing operations by the seller post-closing to be key evidence as to whether there has been an actual change in control of the seller's business, and therefore, a transfer of the privilege. A federal district court in Minnesota noted the lack of evidence of the seller's continued operation post-asset sale and found it demonstrated that the privilege had transferred in the sale. See *United States v. Adams*, 2018 BL 83732, at *3 (D. Minn. Mar. 12, 2018). There, a criminal defendant (an attorney) attempted to assert attorney-client privilege with respect to the legal advice he provided to a seller in an asset sale, where the buyer had agreed to waive privilege. The

Adams court determined that the absence of proof that the seller sold any products after the transaction, continued to pay any employees, honored contracts to any customers, or otherwise carried on as a viable business enterprise demonstrated that control of the continued operation of the seller's business passed to the buyer and thus the privilege transferred as well.

By contrast, a federal district court in Utah concluded that a seller's continued existence and operation of the same or similar business (in however limited a capacity) following a sale and assignment of intellectual property rights made it "incongruous to claim that the 'practical effect' of the [relevant] transactions" transferred control of the business to the buyer, especially where the contract at issue contemplated circumstances in which certain intellectual property rights that were purportedly "sold" could revert back to the seller. See *Applied Asphalt Techs. v. Sam B. Corp.*, No. 214CV00800JNPDBP, 2016 BL 29981, at *5 (D. Utah Feb. 3, 2016).

Similarly, a federal district court in Texas concluded that a seller's continued existence and operation demonstrated no "shift [in] the managerial control of business activities to warrant the passing of the authority to assert or waive the attorney-client privilege." *U.S. Ethernet Innovations, LLC v. Acer, Inc.*, No. 6:09-CV-448-JDL, 2010 BL 467624, at *2 (E.D. Tex. May 7, 2010).

Buyer's Continuation of Seller's Business

Another important issue is the extent to which the buyer has continued the acquired business under new ownership. When a buyer of assets employs a seller's managers and employees, sells to the seller's customers, and continues the seller's operations and/or sells the same product, courts have determined that the privilege related to the business being acquired passes to the buyer. A federal district court in Illinois concluded that when a buyer employed the same personnel, continued operations from the same location, provided the same services, and maintained the same fleet as the seller had, the practical consequence of the transaction "was merely to change the name on the sign above the offices," resulting in the privilege's transfer. *Miskel v. SCF Lewis and Clark Fleeting LLC*, No. 3:14-CV-338-SMY-DGW, 2016 BL 211857, at *6 (S.D. Ill. June 30, 2016).

Many other cases have also concluded that whether the buyer continued the acquired business determined whether the privilege transferred. Compare *USI Ins. Servs., LLC v. Ryan*, No. 1:14-CV-151, 2014 BL 187639, at *4 (N.D. Ind. July 7, 2014) (holding that the attorney-client privilege transferred with the assets, because the asset buyer "conducts the same type of insurance business, from the same location, led by the same leader …, employing most of the same employees, and serving the same clients"), with *Federal Deposit Ins. Corp. v. Amundson*, 682 F. Supp. 981, 987 (D. Minn. 1988) (holding that the FDIC, which had purchased the assets of a bank and was appointed receiver for the purpose of liquidation, could not exercise the attorney-client privilege of the entity from which it purchased assets because "[t]here [was] no thought or effort to reconstitute the entity or to run [the bank] at all").

Language in the Asset Purchase Agreement

Although some courts have held that contractual language alone will not automatically transfer the privilege, language clarifying the parties' intent as to the extent of the change-in-control and intended operation of a business post-closing may aid the court in resolving the issue.

For example, a federal district court in Texas held that the seller's attorney-client privilege had transferred, relying in part on a provision in the parties' agreement stating that "Buyer desires to purchase from Seller, and Seller desires to sell to Buyer, substantially all of Seller's assets and properties used or held for use in connection with the Business." *Array Holdings, Inc. v. Safoco, Inc.*, No. CV H-12-0366, 2013 BL 472265, at *3 (S.D. Tex. Jan. 30, 2013). In light of that contractual language, the court concluded that the parties intended to and had in fact transferred control of the seller's business (and the resultant privilege) to the buyer. But see *American Int'l Specialty Lines Ins. Co. v. NWI I, Inc.*, 240 F.R.D. 401, 407 (N.D. Ill. 2007) (concluding that "an agreement to transfer the attorney-client privilege was not dispositive").

At the same time, some courts have found that contractual language may be used to *limit* the scope of the privilege being transferred despite a change in control of the company, especially the transfer of the privilege attached to documents and communications related to the transaction itself. For example, though the case did not specifically involve an asset sale, the Delaware Court of Chancery concluded that language in the parties' merger agreement assigned post-closing control

of the attorney-client privilege to the seller, insofar as it relates to pre-closing communications. See *Shareholder Representative Services LLC v. RSI Holdco, LLC,* No. CV 2018-0517-KSJM, 2019 BL 196170, at *1 (Del. Ch. May 29, 2019).

Similarly, in the asset sale context, a federal district court in California held that contractual language prohibited the asset buyer, who had taken control of a seller's company, from waiving the attorney-client privilege protecting the seller's pre-sale communications with its attorneys. See *Sentinel Offender Servs., LLC v. G4S Secure Sols., Inc.*, No. SACV14298JLSJPRX, 2015 BL 505941, at *2 (C.D. Cal. Sept. 3, 2015). The parties' asset purchase agreement contained a confidentiality provision stating that "Confidential Information" the buyer would "receive, possess, or become aware of in connection with" the agreement "shall remain at all times the sole property of the [seller]." The agreement defined "Confidential Information" as "any information … relating to [the seller's] business, which is generally not known to Persons other than [the seller] … and which is of value to [the seller]." According to the court, that provision protected the seller's privileged communications occurring prior to the transaction despite the buyer's acquisition of the seller's business because "the parties to such a deal may contract to 'prevent certain aspects of the privilege from transferring.'"

Key Takeaways

Whether the attorney-client privilege transfers from a seller to a buyer in an asset sale is a fact-specific analysis, which typically focuses on whether the seller is selling, and the buyer is purchasing, control of a business that will continue operating under new ownership. In conducting this analysis, and as a practical matter, courts will seek to avoid a situation in which one party to an asset sale controls an ongoing business while another controls that business's attorney-client privilege (unless the parties express a contrary intent).

While it may not be dispositive, clear language in the asset purchase agreement can help clarify the parties' intentions and the nature of the transaction. Buyers who want to assume control of the privilege as it relates to a business being purchased with the intent to continue operating should ensure that the asset purchase agreement clearly reflects that intention. A seller transferring control of a business who wants to retain control over the privilege altogether or exclude certain communications, such as attorney-client communications relating to the negotiation of the transaction itself, should also plainly state that intent in the parties' agreement.

Carefully crafted contractual language can go a long way toward minimizing the risk of unintended consequences.