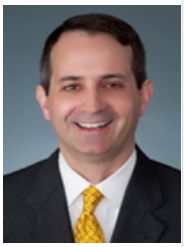
Texas Law Lets Attorney-Client Privilege Transfer to the Buyer of a Business

By Jon Henderson and Reid Johnson of Polsinelli

When negotiating the sale of a business, legal counsel should be aware that the attorney-client privilege protecting communications between the seller and its legal counsel – including negotiations regarding the acquisition – will generally transfer to the buyer if such attorney-client privilege is not otherwise addressed in the transaction documents.



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For example, what if one year after the closing of a transaction in which substantially all of the assets of the company and control of the business were sold to the buyer, the buyer becomes subject to a regulatory investigation and demands access to all pre-closing communications relating to regulatory matters between the seller and its legal counsel, including negotiations regarding the change-of-control transaction?

Unless the transaction documents explicitly excluded attorney-client privilege from the transferred assets or expressly reserved the attorney-client privilege to the seller, the buyer will own the privilege. Therefore, the buyer can waive it and, barring alternative arguments, seller's legal counsel could be compelled to testify against a former client.

The General Rule: Privilege Passes with a Change of Control

Generally, communications between a company and its legal counsel are protected from disclosure by the attorney-client privilege. However, unless otherwise addressed in transaction documents, the attorney-client privilege passes to the buyer after a sale of a business that results in a change of control.

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The U.S. Supreme Court held in *Commodity Futures Trading Commn. v. Weintraub* that "when control of a corporation passes to new management, the authority to assert and waive the corporation's attorney-client privilege passes as well."

The Court additionally stated that: *"New managers installed as the result of a takeover, merger, loss of confidence by shareholders, or simply normal succession, may waive the attorney-client privilege with respect to communications made by former officers and directors. Displaced managers may not assert the privilege over the wishes of current managers, even as to statements that the former might have made to counsel concerning matters within the scope of their corporate duties."*

Texas courts have generally followed *Weintraub* and provided further guidance by explaining in *In re: Cap Rock Electric Cooperative, Inc.* that "the mere transfer of assets with no attempt to continue the pre-existing operation generally does not transfer the attorney-client relationship."

In other words, the transfer of assets must result in an intentional change-of-control and continuation of the purchased business operations: *"The U.S. Supreme Court's decision in Weintraub establishes that, where efforts are made to run the pre-existing business entity and manage its affairs, successor management stands in the shoes of prior management and controls the attorney-client privilege with respect to matters concerning the company's operations."*

Delaware courts have also generally affirmed *Weintrab*'s holding. In *Great Hill Equity v. Sig Growth Equity Fund*, the Delaware Court of Chancery held that a surviving corporation owns and controls any attorney-client privilege that might attach to pre-merger communications, citing Section 259 of the Delaware General Corporation Law, which provides that following a merger, "all property, rights, *privileges*, powers and franchises... shall be thereafter... the property of the surviving or resulting corporation" (emphasis added).

Texas courts have ruled similarly, citing Section 10.008(2) of the Texas Business Organizations Code (formerly Article 5.06 of the Texas Business Corporations Act) and *In re: Cap Rock Electric Cooperative, Inc.*

Consequences of Not Addressing Privilege in Acquisition Documents

In addition to the example above, the following scenarios are examples of possible negative outcomes for the seller resulting from a failure to address the attorney-client privilege in a change-of-control transaction:

- Seller's counsel and the seller have exchanged emails discussing whether a certain liability has to be disclosed on the schedules to the purchase agreement. They ultimately conclude that disclosure is not required. Now that undisclosed liability has resulted in a loss to the buyer and is being litigated. Buyer waives the privilege and compels seller's counsel to disclose such emails and testify as to their context and meaning.
- Before negotiations begin with the buyer, the seller worked with its legal counsel to transfer significant assets to insiders. Now the buyer and the seller are in litigation, and it is clear that the seller's assets will not be adequate to cover the indemnification claims asserted by the buyer. Buyer compels seller's counsel to disclose pre-closing asset transfers.

Proper Privilege Protections

Transferring pre-closing, privileged communications of the seller and its legal counsel is generally an undesirable outcome. Yet it can easily be avoided by addressing the post-closing ownership of the seller's privilege in the relevant transaction documents.

In a transaction involving the sale of substantially all assets of a company, this can be accomplished by expressly excluding such attorney-client privilege from the transferred assets. In other change-of-control transactions, it can be accomplished by including a provision addressing ownership of the company's attorney-client privilege in the purchase agreement or other transaction document executed by the parties.

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