

Who Owns The Privilege After A Merger

BY STEPHEN GILLERS

This is Part II of a two-part article.

In last month's NYPRR, we identified several lawyer regulatory issues of particular concern to corporate and transactional lawyers, whether they work at law firms or in house. Our unabashed motive was to debunk the notion, too widely held, that "ethics are for litigators." Wrong. Rules governing the conduct of lawyers — whether in ethics codes, statutes, court made law, or agency regulations — affect everyone. Indeed, some of the most delicate issues confront corporate lawyers, whether they know it or not.

This month, we concentrate on one issue, and mostly on one particular but important aspect of that issue. The issue is privilege and the aspect is who controls privilege when there is a change of corporate control. Knowing the answer to that question and, more important, knowing that the answer can be contractually altered, can save clients much grief and can also save lawyers from the loss of their clients. This is the lesson of the New York Court of Appeals case discussed here.

Who controls the privilege? In one way, the answer is easy and obvious. Those persons who legally control the entity that owns the privilege also control the privilege. The entity can only make decisions about assertion or waiver of privilege through its agents and the agents are those who, under substantive law, are recognized as having this power. In a unanimous decision in the bankruptcy context, the Supreme Court recognized this view. It held that the trustee in bankruptcy had the power to waive a corporation's privilege for all communications between its counsel and those who had been its officers or directors. *See CFTC v. Weintraub* (1985). Of course, questions may arise over who in the entity has the authority to make these decisions, an authority that can be express, implied, or apparent. But that is a question of agency law, not strictly speaking, of the principles defining privilege. Whoever controls the privilege is also likely to control the entity lawyer's distinct duty of confidentiality.

How Issue Arises In Mergers And Acquisitions

The issue becomes more intriguing when a corporation changes control through a merger or similar transaction. Imagine, for example, that Company A has a subsidiary Company B. Company A negotiates to sell the subsidiary (or merge it into) a shell company (Company X) formed by Buyer specifically to acquire Company B. After the sale, Company X may change its name. In fact, it may change its name back to Company B and for all intents and purposes, Company B will be seen to have been continually in business, with no visible change in its operation.

This in fact is the basic outline of the New York Court of Appeals' careful opinion in *Tekni-Plex v. Meyer and Landis* (1996). The only difference is that in *Tekni-Plex* the entity in the position of Company A was Tang, the individual sole shareholder of Tekni-Plex. Tekni-Plex was merged into a shell corporation

whose name, following the merger, was changed to Tekni-Plex (the court called it “new Tekni-Plex”). Tang made certain warranties in connection with the transaction, including that Tekni-Plex was in compliance with all environmental laws. Eventually, new Tekni-Plex brought an arbitration against Tang, alleging that the company was not in compliance as warranted. The law firm that appeared to represent Tang in that arbitration, Meyer and Landis (“M&L”), had represented Tang and old Tekni-Plex in the merger negotiations and had also represented old Tekni-Plex for some 23 years prior to the merger. It had, in fact, represented old Tekni-Plex on the very environmental matter that now gave rise to the alleged breach of warranty.

So picture the situation: new Tekni-Plex, owned by a successor to Tang, faced Meyer and Landis as the adversary law firm representing Tang. Citing DR 5-108, new Tekni-Plex sought disqualification in state court claiming that M&L had been (it was no longer) its law firm on substantially related matters and was therefore disqualified. From Tang’s point of view, M&L had always been “his” law firm. Even when the law firm represented old Tekni-Plex, Tang might understandably have viewed the firm as his because the company was closely held and Tang was for a time its sole shareholder. It must have seemed strange to Tang that the company that acquired Tekni-Plex could deny him the use of M&L even though the law firm had never represented that company in its new incarnation.

Court Defines Adverse Interests Under DR 5-108

And yet that was the result of the disqualification motion. The court’s reasoning sheds important light on the issue of client identity when control of a corporation changes. It also offers an important lesson about how Tang might have avoided disqualification of “his” long-time law firm.

The standard for disqualification of a law firm based on a former-client conflict is contained in DR 5-108, the analog to ABA Model Rule 1.9. Essentially, the questions are these: Is the party claiming disqualification a former client? Are the matters substantially related? Is the new matter adverse to the interests of the former client?

Here, the first question was especially interesting. It came to this: was new Tekni-Plex a former client of M&L because M&L had once represented old Tekni-Plex. The answer was yes, to a point. The court wrote: “When ownership of a corporation changes hands, whether the attorney-client relationship transfers as well to the new owners turns on practical consequences rather than on the formalities of the particular transaction.” Tang argued that the merger documents identified the acquiring shell corporation (Company X), not old Tekni-Plex, as “the surviving corporation,” and that therefore old and new Tekni-Plex were different entities.

The court disagreed. “Following the merger, the business of old Tekni-Plex remained unchanged, with the same products, clients, suppliers, and non-managerial personnel.” Furthermore, the merger agreement gave new Tekni-Plex

all of the rights, privileges, liabilities and obligations of old Tekni-Plex, in addition to its assets. Certainly, new Tekni-Plex is entitled to access to any relevant pre-merger legal advice rendered to old Tekni-Plex...

As a practical matter, then, old Tekni-Plex did not die. To the contrary the business operations of old Tekni-Plex continued under the new managers. Consequently, control of the attorney-client privilege with respect to any confidential communications between M&L and corporate actors of old Tekni-Plex concerning these operations passed to the management of new Tekni-Plex.

Turning to the second question, the court concluded that there was a substantial relationship between the environmental work M&L had done for old Tekni-Plex and the alleged breach of environmental warranties now asserted by new Tekni-Plex. It was the same matter.

Duty Of Confidentiality Passes To New Firm

The only remaining question was whether the interest of the law firm's current client was materially adverse to new Tekni-Plex. Here the court distinguished between the representation of old Tekni-Plex in the merger negotiations themselves and the work the law firm had done for old Tekni-Plex prior to the merger. With regard to the former, the court wrote that "the parties contemplated a unity of interest between old Tekni-Plex and Tang should a dispute arise between the buyer and seller regarding the representations and warranties. Thus, to the extent the arbitration relates to the merger negotiations ... Tang and old Tekni-Plex remain on the same side of the table."

But, the dispute went "beyond the merger negotiations. It also involves issues relating to the law firm's longstanding representation of the acquired corporation on matters arising out of the company's business operations — namely... environmental compliance matters." The representation of old Tekni-Plex gave it "access to confidential information... concerning the very environmental compliance matters at issue in the arbitration. M&L's duty of confidentiality with respect to these communications passed to new Tekni-Plex; yet its current representation of Tang creates the potential for the law firm to use these confidences against new Tekni-Plex in the arbitration."

Not only was the law firm disqualified, but because Tang had not shown that he was a co-client with old Tekni-Plex in the environmental representations, the firm was enjoined from revealing to Tang any confidential communications obtained prior to the merger negotiations. Tang, however, controlled communications relating to the merger negotiations themselves. At that point, Tang and old Tekni-Plex were adverse to new Tekni-Plex, which "did not succeed to old Tekni-Plex's right to control the attorney-client privilege for this service." New Tekni-Plex "cannot both pursue the rights of the buyer and simultaneously assume the attorney-client rights that the buyer's adversary (old Tekni-Plex) retained regarding the transaction."

Making The Privilege Part Of The Negotiations

The important lesson of this case for lawyers in merger negotiations, apart from the analytical distinctions that will influence court decisions inside and outside the merger context, is that in the merger negotiations themselves, Tang could have bargained for the attributes of the attorney-client relationship (including control of privilege and confidentiality) that would otherwise go to new Tekni-Plex. There is no rule that would prevent new Tekni-Plex from "selling" those attributes or from allowing Tang to retain them. The requirements imposed on lawyers not to engage in former-client conflicts and to protect a former client's confidential information can be waived. DR 5-108. True, new Tekni-Plex might not have agreed to waive those rights, but then again it might have. If the services of M&L were important to Tang, and apparently they were because he took the case to the New York Court of Appeals, he might have

been willing to make concessions on other points in the negotiation in order to be able to enjoy those services in the event of a dispute with new Tekni-Plex.

Lawyers generally think of the law governing lawyers as a shield — i.e., by staying within that law they are protected from varieties of harm. Often, that is the primary objective. But the body of lawyer regulation can also work as a sword. By knowing it and planning around it, lawyers can preserve an advantage that they (and their client) would otherwise have to forego. Tekni-Plex is exhibit A.

TEXT OF DR 5-108: Professor Gillers cites New York's DR 5-108(a). The full text of this subsection follows:

- (a) Except as provided in Section 1200.45(b) with respect to current or former government lawyers, a lawyer who has represented a client in a matter shall not, without the consent of the former client after full disclosure:
 - (1) Thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client.
 - (2) Use any confidences or secrets of the former client except as permitted by section 1200.19(c) of this Part or when the confidence or secret has become generally known.

DR 5-108 was amended in 1999 by the insertion of two new subparagraphs, (b) and (c) dealing with lateral hires.

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