YOUNG CONAWAY STARGATT & TAYLOR, LLP



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IN THIS ISSUE



## Asset Purchase Agreements and the Attorney Client Privilege

*by James P. Hughes, Jr.*

When an asset purchase agreement goes awry and litigation follows, which party holds the attorney client privilege for communications before, during and after the APA is negotiated? This novel but potentially important question was answered recently by the Delaware Court of Chancery in a decision that applied New York law, but that will likely have implications for practitioners everywhere in light of the few cases that have addressed this issue.

*Postorivo v. AG Paintball Holdings, Inc.*, C.A. No. 2991 (Del. Ch. Feb. 7, 2008), involved a sale of assets in which the defendant purchasers acquired substantially all of the plaintiff's business, while the plaintiff retained certain excluded assets and liabilities including an ongoing litigation. With respect to the litigation asset, the parties negotiated an option that entitled the purchasers to acquire all of the assets and liabilities associated with the litigation (the "Litigation Option"). Disagreements over the valuation of the Litigation Option, and other aspects of the transaction, followed soon thereafter, leading to separate lawsuits that were consolidated in the Court of Chancery.

The suits raised privilege issues with respect to three types of communications: (1) communications before and after the APA that impacted the ongoing operation of the entity acquired by the purchasers; (2) communications surrounding negotiations over the APA, and (3) communications regarding the excluded assets and liabilities, including the Litigation Option.

With the court's guidance, the parties apparently reached agreement before the issuance of the court's decision that the purchasers held the attorney client privilege for communications "impacting the ongoing business of the post-acquisition entity, including *pre-APA documents and communications*." Slip op. at 8 (emphasis added). The court noted that this understanding was supported by a holding of the New York Court of Appeals, in a case involving the question of whether the purchaser of a business could disqualify an attorney from representing the seller in a post-merger litigation where the attorney had previously represented the seller's business on (i) several pre-merger matters and (ii) the negotiations culminating in the merger agreement. The Delaware Court explained that the New York case stood for the proposition that, "When the successor merely purchases assets and does not attempt to continue the pre-existing operation, generally the attorney-client privilege does not transfer. By contrast, when the successor continues the operations of the predecessor company, the successor company stands in the shoes of prior management and holds

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the privilege with respect to communications regarding the company's operations." *Id*. at 10-11

With respect to the understanding reached in the Delaware case with regard to the purchaser's right to assert privilege over *pre-APA* communications, it bears emphasis that the purchase agreement included substantially all of the entity's assets including its real property, inventory, equipment, contracts, intellectual property, files, records, security deposits, claims, investments, and cash. *Id*. at 4. The fact that the purchase agreement included items that are typically retained by sellers in an asset sale may have contributed to the perception that the asset sale was nearly as inclusive as a stock sale, thereby justifying the transfer of the privilege to the purchasers. *Cf*. Egan, "Asset Acquisitions: A Colloquy," 10 *U. Miami Bus. L. Rev*. 145, 150 (Winter/Spring 2002) ("[A]ssets to be excluded and retained by the seller [in an asset sale]…often [include] cash, accounts receivable, litigation claims or claims for tax refunds, personal assets and certain records pertaining only to the seller's organization."). Although not addressed by the court, it seems likely that a much more limited asset sale may have created a different result with respect to the scope or extent of the purchaser's privilege rights.

In any event, both the New York and Delaware cases held that control over any *pre-merger* communications that arose between the lawyer and the entity prior to the entity being sold now belonged to the purchasers because of the close identity between the pre- and post-merger entities. The New York court concluded that this was a logical result because the purchasers would have to rely on pre-merger communications if called upon to prosecute or defend against third-party suits involving any assets, rights or liabilities that implicated the acquired business.

The Delaware court then considered who controlled the attorney client privilege with regard to communications between the lawyer and the seller as it related to the negotiations over the Purchase Agreement itself. The court held that the *seller* still retained the privilege because at the time of the negotiations, the seller and the entity being sold were adverse to the purchaser, and the purchaser's putative privilege claims did not spring from any rights it inherited in the assets, but rather, emanated solely from the Purchase Agreement. *Postorivo*, slip op. at 13.

The Delaware court then considered whether the purchasers could control the attorney client privilege with respect to the Litigation Option. The sellers argued that because they needed to control the ongoing litigation underlying the Litigation Option, they were entitled to retain control over the legal advice being provided. The purchasers argued that in an asset transfer involving substantially all of an entity's assets, the sellers' privilege passed as a whole, because the privilege is an "incident of control and cannot be split among several different entities, even if a written contract among the parties provides to the contrary." *Id*. at 14.

Under the terms of the APA, the sellers were required to cooperate with the purchasers for purposes of deciding whether to exercise the Litigation Option. Notwithstanding this clause, the court concluded that other clauses in the APA, including one that tempered the cooperation clause by making it subject to restrictions necessary to preserve the privilege, reflected a "clear recognition" that the seller would retain the privilege as to the Litigation Option. *Id*. at 15. In addition, the court was influenced by "practical considerations," and concluded that it would be impractical for the seller to prosecute and defend the underlying litigation without the ability to assert or waive privilege. *Id*. at 19.

*Where the assets being sold include items typically retained by the seller in an asset sale, such as cash and receivables, there appears to be a greater likelihood that the privilege will be construed as shifting to the purchaser.*

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As the foregoing suggests, the *Postorivo* case has several practical implications for attorneys to bear in mind when negotiating an asset purchase agreement, particularly where an attorney has represented a company on various matters prior to commencing purchase agreement negotiations.

*First*, where most of the assets of an ongoing enterprise are being sold, control over privileged communications that arose pre-sale will potentially be construed as belonging to the purchaser after the sale. Where the assets being sold include items typically retained by the seller in an asset sale, such as cash and receivables, there appears to be a greater likelihood that the privilege will be construed as shifting to

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the purchaser. As a practical matter, a transfer of control over the privilege to the purchaser could result in (i) seller's counsel being required to turn over files concerning matters that arose pre-sale, and (ii) seller's counsel being precluded from communicating with the former owners of the business with regard to matters that arose pre-sale.

*Second*, with respect to communications that arose specifically with regard to the negotiations over the purchase agreement, the seller will likely be able to assert privilege with regard to communications emanating from the agreement itself.

*Third*, where a seller retains assets for which the purchaser secures an interest or an option, the seller's ability to assert privilege with respect to those assets will likely turn on the exact terms of the purchase agreement and which of the parties has a greater practical need to assert the privilege. ‡

## Actions Taken at a Board Meeting without Proper Notice Are Void and Cannot Later Be Ratified

*by Evangelos Kostoulas*

A recent decision by the Delaware Court of Chancery has underscored the need for corporate formalities to be observed when the board of directors of a Delaware corporation takes action. In *Fogel v. U.S. Energy Systems, Inc.*, Chancellor Chandler reviewed an attempt by the U.S. Energy Systems board to remove the company's CEO and found it wanting. C.A. No. 3271-CC, 2007 Del. Ch. LEXIS 178 (Del. Ch. Dec. 13, 2007).

In *Fogel*, a board meeting had been noticed for June 29, 2007, for the stated purpose of interviewing and hiring a financial adviser for U.S. Energy Systems. As the meeting date approached, three of the company's four directors came to agree among themselves that they should remove the company's CEO, Fogel, who was also the fourth director and the chairman of the board. On the day of the meeting, the three directors confronted Fogel in the board room where the meeting was to take place. One of the three gave Fogel an ultimatum: either he would resign as CEO and chairman by the end of the day, or the board would fire him. Fogel then left the premises, and the remaining directors conducted the board meeting as planned. Later that evening, one of the directors called Fogel to ask if he would resign. When Fogel refused, the director informed him that he was terminated.

Two days later, on July 1, Fogel called for a special meeting of stockholders for the purpose of removing the other directors, pursuant to his authority as CEO and chairman under the company's bylaws. Later that day, during a scheduled board meeting, the other directors formally passed a resolution purporting to ratify Fogel's termination as CEO and chairman. Those directors ignored Fogel's call for a stockholders' meeting.

Fogel then sued the company and his fellow directors, seeking, among other things, an order that the stockholders' meeting be held. Fogel argued that the June 29 gathering, when the ultimatum was delivered, did not effectively remove him as CEO and chairman, and that he therefore still had the authority to call a stockholders' meeting on July 1, before the board took its formal action later the same day.

In its post-trial opinion, the Court agreed with Fogel. First, it found that the June 29 gathering was "insufficient to constitute a [board] meeting under Delaware law." There was no "formal call to the meeting," no discussion, and no vote. Second, the Court held that even if the gathering on June 29 did constitute a board meeting, any action taken at it was void because Fogel's attendance had been obtained "by deception." Directors must receive notice of a board meeting sufficient to allow them "an adequate opportunity to protect [their] interests" (alteration in original; internal quotation marks omitted). If a director is "tricked or deceived about the true purpose of a board meeting, and where that director subsequently does not participate in that meeting, any action purportedly taken there is invalid and void." Third, the Court held that the board's ratification of Fogel's termination at the meeting on July 1 was ineffective because (as the Court had just held) the action purportedly being ratified was void. "When a corporate action is void, it is invalid *ab initio* and cannot be ratified later." It followed that the board's July 1 action terminating Fogel could not relate back to the time before he had called the stockholders' meeting in his capacity as CEO and chairman.

The *Fogel* decision thus demonstrates the importance of observing formalities when board action is taken. Since Fogel did not receive notice that the June 29 board meeting would address his termination as an officer, and since he did not waive notice by participating in the June 29 meeting, the other directors' first attempt to terminate his service was void. And because that attempt was void, the directors could not later ratify it at a properly called meeting. ‡

# About the Update

The *Delaware Transactional & Corporate Law Update* is published semi-annually by the Business Planning and Transactions section of Young Conaway Stargatt & Taylor, LLP.

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