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Inside Ethics

Retaining privilege despite losing control of your subsidiary

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In corporate families, the legal department of the parent often provides advice to the subsidiaries. That arrangement can lead to headaches if later there is a change in control of the subsidiary. Consider the following example.

The scenario

You are the general counsel of Axon Corporation. Early one morning your CEO calls and asks you to get in touch with John Smith, a senior vice president at Axon and the president of Gonzo Corporation.

Gonzo, which Axon recently purchased amid much fanfare and high expectations, is one of Axon's several wholly-owned subsidiaries. Apparently, Gonzo owes a substantial amount of money to its suppliers, the suppliers' patience is wearing thin, and Smith needs a legal perspective on Gonzo's options.

The request comes as no surprise to you since, in your capacity as general counsel of Axon, you routinely provide legal advice to Axon's subsidiaries.

You place a call to Mr. Smith, and during that conversation and in other calls, meetings, and e-mail exchanges over the next several days, you provide legal advice to Smith and other Gonzo officers, some of whom are also officers of Axon, about the debts that Gonzo owes to its creditors.

Among the options discussed is the possibility that Axon will provide additional funding to Gonzo. The pros and cons of declaring bankruptcy are also weighed. You request and receive from Axon's outside counsel a memorandum analyzing the legal implications of the various options, which you discuss with Smith and with Axon's CEO.

One month later, swamped by its debts, Gonzo declares bankruptcy. The bankruptcy court appoints a trustee who files a lawsuit against Axon in federal court, alleging that Axon took (or failed to take) a variety of steps that caused Gonzo's bankruptcy.

The trustee serves a request for the production of documents on Axon. Documents responsive to the request include the memorandum that Axon's outside counsel prepared at your request, as well as the notes, memoranda, and e-mails that you and other Axon employees prepared in the course of your discussions about Gonzo's difficulties.

Axon's trial counsel objects to the production of those documents on the ground that they are protected by the attorney-client privilege, and identifies them on Axon's privilege log. Shortly thereafter, the trustee's counsel deposes you on your communications with Axon's CEO, Smith, and others concerning Gonzo's problems. You refuse to answer on the advice of counsel.

The trustee's counsel files a motion to compel the production of your documents and testimony. He argues that you were representing Gonzo when the communications at issue took place; and, since the trustee now controls Gonzo, communications with Gonzo officers are not privileged *from disclo*sure to him.

Further, he argues that since you were representing both Gonzo and Axon with respect to Gonzo's difficulties, your communications with Axon personnel (*e.g.*, its CEO) and its outside counsel are within the scope of the joint representation and should also be disclosed.

In opposing the motion to compel, Axon's counsel argues that because Gonzo was a wholly-owned subsidiary of Axon when the communications occurred, and because Axon and Gonzo shared the same interests at the time, Axon's intent that its privileged communications would remain protected should control.

The outcome

Unfortunately, Axon loses the argument and the court orders the production of documents and testimony.

Why?

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In *Commodity Futures Trading Commission v. Weintraub*, (471 U.S. 343, 358 (1985)), the U.S. Supreme Court held that the trustee of a corporation in bankruptcy holds, and thus has the power to waive, the corporation's attorney-client privilege with respect to pre-bankruptcy communications.

Thus, any communications that you had with an employee of Gonzo in his or her capacity as such – even if, like Smith, the employee was also an officer of Axon – cannot be withheld from the trustee.

Further, to the extent you jointly represented Axon and Gonzo about Gonzo's performance issues and how to address them, any communications within the scope of that joint representation are fully discoverable by Gonzo's trustee. *See In re Teleglobe Comms. Corp.*, 493 F.3d 345, 366 (3d Cir. 2007). That goes not only for your communications with non-Gonzo Axon employees, like your CEO, but also for the legal analysis memorandum that you asked outside counsel to prepare. *Id.* at 387.

It is worth noting that whether a joint representation existed and what was its extent depends on the intent and expectation of the parties to the supposed representation. *Id*. at 362-63. Inquiries about intent and expectation are obviously fact-intensive and are likely to be hotly contested. *Id.* at 386-87 (remanding for further findings about the alleged joint representation.)

In the case of Axon and Gonzo, however, a joint representation clearly existed and encompassed the communications at issue.

This nightmare scenario is not restricted to the bankruptcy context. Any time a corporate parent gives up management control over a subsidiary, there is a possibility that communications previously assumed to have been privileged could lose their protection – at least as to your former subsidiary's new management. *See, e.g., In re Grand Jury Subpoenas*, 902 F.2d 244, 248 (4th Cir. 1990). S*ee also* Restatement (Third) of the Law Governing Lawyers, § 73 cmt. k ("[w]hen ownership of a corporation or other organization as an entity passes to successors, the transaction carries with it authority concerning asserting or waiving the privilege.").

Say, for example, that Axon had sold Gonzo to Beta Corporation before Gonzo declared bankruptcy. If Beta were later to allege that Axon had misrepresented Gonzo's financial condition, your communications relating to the sale with Gonzo employees – or with Axon's employees and outside counsel, if you were found to have been jointly representing Axon and Gonzo – could be discoverable in Beta's lawsuit against Axon. *See, e.g., Polycast Tech. Corp. v. Uniroyal, Inc.*, 125 F.R.D. 47, 49 (S.D.N.Y. 1989).

Avoiding disclosure

How could you have avoided this outcome?

The first key, of course, is to be aware of the issue. Because inside counsel for large corporations routinely provide legal advice to the corporation's subsidiaries, they may fail to recognize when their advice relates to a transaction resulting in a loss of control over the subsidiary – and thus also of control over the privilege. It is vital to remain aware of and alert to this possibility in your dealings with subsidiaries.

Once you've recognized the issue, there are several things you can do to address it.

First, you can arrange for the retention of independent counsel for the subsidiary. If the subsidiary has its own counsel, it is unlikely that a court will find that you were jointly representing both the subsidiary and the parent – and your communications with the parent will be protected from disclosure in any subsequent litigation with the new management of the subsidiary. *See, e.g., Teleglobe*, 493 F.3d at 373.

As the 3rd Circuit noted in *Teleglobe*, the fact that the parent and subsidiary have separate counsel with respect to a transaction that may or will result in the parent's loss of management control over the subsidiary "does not mean that the parent's in-house counsel must cease representing the subsidiary on all other matters. After all, spin-off transactions can be in the works for months (or even years), and during that time it is proper (and obviously efficient) for in-house counsel to continue to represent the subsidiary (jointly or alone) on other matters." 493 F.3d at 373.

Second, to the extent the transaction involves a sale of the subsidiary (as opposed to a declaration of bankruptcy), you may be able to structure the transaction as an asset sale, rather than a sale of the subsidiary itself. Courts have held that the mere transfer of assets, with no attempt to continue the pre-existing entity, generally does not result in a transfer of the attorney-client privilege. *See, e.g., In re Cap Rock Elec. Coop, Inc.*, 25 S.W.3d 222, 227-28 (Tex. App. 2000).

Third, you can enter into an agreement with the prospective owners of the subsidiary providing that all of your communications with the management of the parent, the subsidiary, and outside counsel relating to the disposition are privileged and will be treated as such in any subsequent litigation between the parties. *See* Restatement (Third) of the Law Governing Lawyers § 75 cmt. d.