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NEWSLETTERS

Selling Out On Attorney-Client Privilege: Asset Acquisitions As A Trap For The Unwary Business Lawyer

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Attorney-client privilege is for sale. This probably came as a real shock to Minnesota attorney Edward Adams, who helped orchestrate the sale of two businesses' assets. Little did he realize what else was included in the terms of the deal.

In 2011 and 2012, Mr. Adams and his law firm provided legal assistance for the asset purchase of Apollo Diamond, Inc. and Apollo Diamond Gemstone Corporation by Scio Diamond Technology Corporation. In 2016, Mr. Adams came under federal investigation for embezzlement of funds. Government investigators obtained a search warrant to search the contents of Mr. Adams' email accounts. In response, counsel for Scio contacted the U.S. Attorney's office stating that Scio would not assert any attorney-client privilege or confidentiality protections related to services performed by Mr. Adams or his firm related to the Apollo transaction. Mr. Adams countered, claiming that the privilege remained intact for emails providing legal advice to Apollo and filed a motion in the U.S. District Court for the District of Minnesota to protect the Apollo emails from disclosure.

The key issue before the Minnesota federal court was whether Scio could waive attorney-client privilege over the communications between Mr. Adams and Apollo simply by virtue of Scio's purchase of assets from Apollo. In holding in *United States v. Adams* (D. Minn. 2018) that Scio could properly waive privilege, the court focused on the key distinction of what was actually transferred from Apollo to Scio.

The court explained that, generally, when control of a corporation passes to new management, the authority to assert and waive the privilege passes as well, based on a U.S. Supreme Court decision in *Commodity Futures Trading Comm'n v. Weintraub* (1985). The attorney-client relationship, however, can also transfer in situations involving sale of less than all the organizations assets; the court cited *Parus Holdings Inc. Banner & Witcoff, Ltd.* (N.D. Ill. 2008). In such circumstances, courts have applied the "Successor Test." Under the successor test, the mere transfer of a corporation's assets does not pass the privilege to the acquiring corporation unless: (1) the sale also transferred control of the business; and (2) the acquiring corporations' management continues the business of the selling corporation.

In applying the successor test, the court first looked to the practical realities of an asset sale rather than simply the formalities of the transaction. A critical fact, the court acknowledged, was the language of the asset purchase agreement itself which transferred all of Apollo's intellectual property rights, website, equipment, machinery, and inventory, as well as numerous other tangible and intangible assets. The court found that this broad transfer constituted essentially every asset needed for continuation of Apollo's business. This was reflected in the business dealings, given that post-sale, there was no evidence that Apollo continued operating in any meaningful way – Apollo did not sell any products, pay any employees, honor any contracts to provide materials to customers, or otherwise carry on a viable business enterprise.

In short, the court determined that the asset sale was, in effect, a transfer of the entire business. In addition to the practical realities of the asset sale, the court explained that the statements of those involved buttressed the conclusion that the entire business transferred to Scio. In testimony before the Securities and Exchange Commission, Mr. Adams described the transaction as "allow[ing] the company to kind of reboot." Further, Mr. Adams' attorneys wrote that "Scio now owns all assets of former Apollo & Gemstone entities." This was reiterated in communications with shareholders, which repeatedly referred to the sale of substantially all of Apollo's assets for future continuation of the business by Scio.

In his defense, Mr. Adams argued that control did not pass to Scio because the asset purchase agreement noted that Apollo retained certain excluded assets and did not transfer its liabilities. Further, Mr. Adams noted that Scio itself referred to the transaction as an asset purchase rather than the purchase of the business. The Court found that these technical arguments elevated form over substance in light of the functional realities of the sale. The purported retained assets were neither necessary nor useful for the continuation of Apollo's business. Finally, a review of prior case law concluded that Apollo's non-transfer of liabilities did not equate to the retention of its privilege.

In sum, the Minnesota federal court found that Scio was, for all intents and purposes, a successor to Apollo and therefore, Scio held the power to assert and waive Apollo's attorney-client privilege. The court also considered Mr. Adam's privilege claims with respect to communications with his accountant, and instructed Mr. Adams to create a privilege log for continuing claims in light of the court's ruling on the Apollo transaction privilege claims.

A main takeaway for corporate counsel was recognized by Mr. Adams himself, albeit in hindsight. Citing a New York Court of Appeals decision in *Tekni-Plex, Inc. v. Meyer & Landis* (N.Y. 1996), Mr. Adams argued that even if even if the attorney-client privilege passed to Scio, Apollo retained the privilege with regard to the asset purchase negotiations. However, the court easily distinguished the *Tekni-Plex* transaction where the parties anticipated and specified that the rights of the acquired corporation would remain independent from and adverse to the rights of the acquiring corporation. Corporate counsel should be conscious that privileges of the acquired corporation will be incidents of the sale unless explicitly stated otherwise within the purchase agreement.

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