

Attorney-Client Privilege in Closely-Held Entities

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What is the Attorney-Client Privilege?

The attorney-client privilege protects confidential communications between attorney and client made for the purposes of securing or giving legal advice from compelled disclosure. It is:

- One of the oldest evidentiary privileges in Anglo-American law
- Intended to promote free flow of information between attorneys and their clients
- Traditionally a product of common law, but codified in many states
- Distinct from the work product doctrine and the duty of confidentiality
- Burden is on the party claiming privilege to establish it

Application of the Attorney-Client Privilege to Closely-Held Entities

The attorney-client privilege attaches to the entity, not to the individual employees who communicate with counsel. Similarly, the decision whether to waive the privilege belongs to the entity, and not to its employees.

Three important questions:

- Whose communications are protected within the entity's privilege?
- Who within the entity may assert or waive the privilege?
- Who among the entity's constituents may access the entity's privileged communication?

Whose Communications Fall Within the Scope of the Entity's Privilege?

Tests vary by jurisdiction, but two major approaches:

- Majority Rule/Federal Rule: *Upjohn* Subject Matter Test
- Minority Rule: Control Group Test

Majority Rule/Federal Rule: *Upjohn* Subject Matter Test

When corporate counsel speaks confidentially with a corporate employee to assist her in providing sound legal advice to the corporation, those communications are privileged. [*Upjohn v. United States*, 449 U.S. 383 (1981)]

Factors courts consider:

- Did the employee communicate with the lawyer at the direction of the employee's superior?
- Whether the employee know that the purpose of the communication was to obtain legal advice for the entity?
- Was the communication about a subject within the scope of the employee's duties?

Minority Rule: Control Group Test

Communications between a corporate employee and the corporation's lawyer is privileged only if the employee is in the entity's "control group", i.e., is in a position to control or take substantial part in the determination of corporate action in response to legal advice or has authority to obtain legal representation on behalf of the corporation.

Examples: CEO, CFO, President, other top level management employees

Comparing Approaches to Entity Privilege Law

Subject Matter Test/Upjohn

- Applies in federal court in **non-diversity** cases
- Adopted in a majority of states in some form
- Confidential communications between entity's lawyer and employees privileged
- Most, but not all courts have extended *Upjohn* to former employees

Control Group Test

- Still followed in some form in a few states
- Only communications with “control group” privileged (expanded in some states to include, e.g., advisors to top management)
- Former employees not within privilege

Maintaining and Protecting the Privilege

- Maintain confidentiality within the entity – You are ethically bound to anyway
- Know the law and treat communications in a way that will protect them under even the narrowest control group test - choice of law issues
- Share communications only within people within the privilege
- Go through chain of command for lower level employees
- Control how communications are made and educate the client constituents about how to handle privileged communications and information – AND REMIND THEM
- Clearly mark privileged communications, but do not overuse privilege marking
- Be PROACTIVE about protecting privilege and ON GUARD about who participates in meetings and conference calls and who is included in email communications

Special Tips for Dual Role Lawyers

- The attorney-client privilege only protects communications made for the purpose of seeking legal advice.
- In house counsel and others who provide both legal advice and business advice must be aware that not all of their communications are privileged
- Must pay particular care to which “hat” you are wearing when communicating with entity representatives and treat your communications accordingly
- Make clear when rendering legal advice and consider memorializing it in writing
- Consider whether separate communications on legal matters are necessary or advisable to provide broadest protection possible
- While Model Rules allow an attorney to act as both legal counsel and director subject to conflict of interest rules, communications as a director are not privileged – client must be advised of the risk

Joint Representation

The prevailing rule is that there is no privilege among the jointly represented parties when the entity's lawyer also represents one or more constituents.

- Privilege still intact as to third parties
- Privilege is distinct from the attorney's duty of confidentiality [MRCP 1.6], which continues to run to each separate client unless the clients have agreed otherwise (which they typically do).

Practice Tips

- Obtained written informed consent about privilege from joint clients
- Discuss and document agreement about sharing confidential information

Who within the entity may assert or waive the privilege?

First Question: Who Owns the Privilege?

The privilege belongs to the entity, not the individual speaker. There are exceptions (e.g., organizers who reveal confidential information unrelated to the formation of the entity; attorney-client relationship by implication; etc.)

- MRCP 1.13(f) requires attorneys for entities to explain that they represent the entity not the individual and the fact that the entity owns the privilege when communicating with an employee if the attorney has reasons to know the interests of the employee and the entity are not aligned
- **Best practices?** Have this discussion with the employee even if no actual adversity of interests is identified and consider putting it in writing

Who within the entity may assert or waive the privilege?

Next Question: Who actually has the power to assert the privilege?

The power to assert or waive the privilege rests with the entity's management, and is normally exercised by officers and directors.

Management must exercise the privilege in a manner consistent with their fiduciary duty to act in the best interests of the entity, not influenced by their own interests.

Who within the entity may assert or waive the privilege?

Tricky Question: What do you do when management is at odds?

- Counsel should not take sides or get caught in the middle of a dispute among constituents
- Counsel's duty is to the entity - assert and protect the entity's privilege to the broadest extent possible
- Who may assert or waive the privilege is closely tied to the sometime vexing question of which corporate constituents may access privileged communications in closely-held entities

Who May Access The Entity's Privileged Communications?

An entity's privileged communications are protected against disclosure to third parties who are not currently and have never been corporate constituents – subject to same limitations as an individual's privilege (scope of privilege, waiver, etc.)

Much more difficult questions when it comes to current and former corporate constituents:

Current directors need access to fulfill their fiduciary duties – when can the corporation, through other directors, limit a director's access to the entity's privileged communications?

Former directors used to run the corporation and had access to privileged communications during their tenure – what happens when they leave and sue?

Shareholders own the corporation – does this entitle them to access the company's legal advice?

Who May Access The Entity's Privileged Communications?

Current Directors

Board of directors is the governing body of corporation. Sitting directors need access to basic information about the corporation they manage to fulfill fiduciary duties and have a near absolute right to inspect company's books and records, including privileged legal advice the corporation seeks and obtains.

Issues arise when there are disputes among directors or a director sues the corporation. In those instances, the question typically arises whether the minority/dissenting directors are entitled to access the entity's privileged communications.

Courts apply three broad approaches :

- (1) Joint client rule - automatic access for directors
- (2) Entity as client rule - strict construction of the privilege/bright line distinction between entity and directors
- (3) Emerging adversity exception (MA, NY, DE)

Who May Access The Entity's Privileged Communications?

Directors – Joint Client Rule

The joint client rule recognizes directors as the governing authority in a corporation and gives all directors automatic access to attorney-client privileged material by virtue of their position.

It is based on the idea that there is one collective corporate client which includes the corporation and each individual member of the board of directors.

Who May Access The Entity's Privileged Communications?

Directors – Entity as Client Rule – Modern Trend

Some states draw a bright-line distinction between the corporation and its directors, and permit corporations to withhold privileged communications even from directors.

Who May Access The Entity's Privileged Communications?

Directors - Emerging Adversity Exception

A new approach that seeks to strike a balance between the two traditional approaches by establishing the right of all directors to access the entity's attorney-client communications, while shielding those communications made when there is specific adversity between a director and the corporation.

What is adversity?

Must be adversity towards the corporation, not the other directors and shareholders.

Fact specific and depends on the circumstances of each case.

Chambers v. Gold Medal Bakery, Inc., (Massachusetts – 2/2013)

Barasch v. Williams Real Estate (NY – 3/2013)

Kalisman v. Freedman (DE – 4/2013)

Who May Access The Entity's Privileged Communications?

Practice Tips

1. Do not side with one faction when directors are at odds
 - Potential conflict issues
 - Communications may not be privileged
2. Consider advising the board to appoint a special committee and for special committee to consult a lawyer when there is a legitimate need for some directors to be able to consult with a lawyer without including all directors
 - Board vote to form special committee **openly and with knowledge of** the excluded director
 - Special committee retains counsel
 - Advise individual directors to hire (and pay for) their own lawyers
 - Scope of protection for special committee's privilege is unsettled

Who May Access The Entity's Privileged Communications?

Former Directors/Officers

Former directors and officers often seek access to the corporation's privileged communications in litigation against the company or other directors and shareholders on the theory that they were within the circle of privilege when the communications took place.

Whether a former director is entitled to access the privileged documents depends on how the court views the corporate privilege:

- Collective corporate client approach – former officers/directors may obtain documents they received or reviewed, authored or reasonably had access to during their tenure
- Entity as client approach – current directors may assert privilege against former officer/directors even for communications to which they had access as officers or directors

Who May Access The Entity's Privileged Communications?

Former Directors/Officers- Tips for Protecting Entity Privilege

Given the trend toward entity-as-client approach, counsel should take steps to ensure broadest protection possible from a former director/officer attempt to obtain privileged communications:

- Clearly identify client as the entity, not the individual directors and officers in the engagement letter.
- Educate current directors and officers on how best to establish and preserve the privilege and the potential ways in which the privilege may be lost and pierced.
- Give *Upjohn* warnings when a director or officer asks in house or outside counsel a question relating to his or her individual capacity
- Warn current management not to share and to prohibit employees from sharing documents and emails with former directors and officers
- Advise management to protect the privilege by limiting what departing directors, officers or other employees take when they leave the company's employment (use appropriate confidentiality and nondisclosure agreements, etc.)

Who May Access The Entity's Privileged Communications?

Shareholders

- Unless they are also directors or officers, not involved in day-to-day management
- Much narrower inspection and access rights than directors
- Not typically within the corporation's circle of privilege or entitled to access the entity's legal advice or privileged communications.

Fiduciary exception rule ("*Garner*" rule) - Narrow exception in the context of shareholder derivative suits

Who May Access The Entity's Privileged Communications?

Shareholders – Fiduciary Exception Rule (“Garner rule”)

- Permits shareholders in derivate actions to pierce the corporate attorney-client privilege on a showing of “good cause”
- Exception arose in trust context, but extended to corporate context in *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971)
- Premised on idea that shareholders are beneficiaries of the fiduciary duties the board of directors and corporate counsel owe to the corporation
- Highly fact-specific showing - requires analysis of nine non-exclusive factors focused on, among other things, the nature of the shareholder’s claims; the shareholders’ need for the information; and the nature of the information sought.
- Burden is on the plaintiff shareholder to establish good cause
- Not all jurisdictions follow the Garner rule and when they do, it is often with modifications

Who May Access The Entity's Privileged Communications?

Shareholders – Fiduciary Exception/Garner Rule– Non-Exclusive Good Cause Factors

- the number of plaintiff shareholders and the percentage of stock they represent
- the bona fides of those shareholders
- the nature of the shareholders' claim and whether it is obviously colorable
- the apparent necessity or desirability of the shareholders having the information and the availability of it from other sources
- whether, if the shareholders' claim is of wrongful action by the corporation, the action was criminal, illegal but not criminal, or of doubtful legality
- whether the communication related to past or to prospective actions
- whether the communication is of advice concerning the litigation itself
- the extent to which the communication is identified versus the extent to which the shareholders are blindly fishing
- the risk of revelation of trade secrets or other information in which the corporation has a confidentiality interest for independent reasons

Waiver of the Attorney-Client Privilege

When all else fails, waiver?

When a corporate constituent is unable to obtain access by arguing he or she is within the circle of privilege, they often argue that the corporation waived the privilege.

Two common waiver arguments:

- (1) Presence of third parties
- (2) “At issue” Waiver

Waiver of the Attorney-Client Privilege

Presence of Third Parties

The presence of third parties waives the attorney-client privilege (e.g., accountants, key investors or business advisors).

Potential exceptions:

- Presence of third party may not destroy privilege if **necessary to the provision of legal advice** (consultants, accountants, other outside agents of corporation), but very limited exception
- Documents and information prepared by third party experts during internal investigation or audit may be protected if **prepared at request of legal counsel** for purposes of providing legal advice.
- If attorney-client privilege does not attach, work product protection may be available. Touchstone is **whether presence of third party makes it likely the communication will make it to the adversary.**

Waiver of the Attorney-Client Privilege

“At issue” Waiver

A litigant implicitly waives the attorney-client privilege, at least in part, by injecting certain claims or defenses that rely on privileged information into the case.

- Common issue raised in intra-entity litigation
- Core principle is that a party may resist discovery on the basis of privilege, but may not at the same time rely on the privileged communications or information as evidence at trial.

Crime/Fraud Exception

The crime-fraud exception eliminates the privilege for communications when a client seeks or obtains the services of an attorney to commit or to plan to commit what the client knew or reasonably should have known was a crime or fraud.

- Typically applies only to **ongoing or future** crime or fraud only (not fully completed conduct), but some courts apply the exception to other egregious misconduct.
- Party seeking access must satisfy a two-part test: (1) must make a prima facie showing that the client was committing or intending to commit a fraud or crime; (2) must also show that the communications at issue were in furtherance of that alleged crime or fraud.
- **Focus is on the client's knowledge and conduct**; attorney need not be actively participating in the crime or fraud or even have knowledge of it.

Wrap Up

Closely-held entities present difficult questions for counsel and management about which communications are privileged, who may assert a privilege and which corporate constituents may access privileged communications. There is little certainty in this context, but there are steps counsel can take to best position the entity to protect its communications with counsel.

It is important to be proactive from the outset and to be vigilant of privilege issues throughout the engagement. Educating management, crafting policies on how constituents can and should deal with confidential and privileged communications, and identifying what role counsel is playing and when counsel is rendering legal advice are all important to protecting the entity's privilege.

Perhaps above all else, guarding against taking sides or becoming personally involved when constituents are at odds keeps counsel focused on the interests of its client, the entity.

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