State Attorney-Client Privilege Incorporated Into Federal Law

By Robert J. Stearn, Jr., Cory D. Kandestin and Christopher M. De Lillo

Fraudulent transfer plaintiffs frequently challenge transactions that they say contributed to the company's insolvency: leveraged buyouts, cash-out mergers, share redemptions or other major transactions where the company parts with assets or incurs liabilities. State law (often Delaware law) typically governs these types of transactions, and structuring them usually requires the involvement of attorneys, financial professionals and sometimes investment bankers.

Because state law applies at the time the transaction is negotiated, the parties might assume — reasonably so — that state privilege law will govern communications with their attorneys and financial professionals. But what happens if, years later, a fraudulent transfer plaintiff files suit in federal court and brings claims under federal law? Does state privilege law still apply?

The answer matters, because the Delaware attorney-client privilege protects a broader array of communications involving financial professionals than does federal privilege law. Would communications that were privileged when they were made lose such status years later? Would a federal court honor

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Delaware's privilege rule even though federal law typically would not treat the same communications as privileged?

The United States Bankruptcy Court for the District of Delaware recently addressed these questions. In a bench ruling, Judge Kevin Gross applied federal privilege law to a mix of federal and state law claims, and held that because the communications at issue arose from a merger governed by Delaware law, federal privilege law in this instance would apply the same broad rule that Delaware state law would apply to the communications. *PAH Litigation Trust v. Water Street Healthcare Partners, L.P., et al.* (*In re Physiotherapy Holdings, Inc., et al.*), Case No. 13-12965 (KG), Adv. No. 15-51238 (KG) (Bankr. D. Del. Apr. 26, 2018) (Apr. 26, 2018 Hr'g Tr.) [Adv. D.I. 842]. On the facts of the case, the court expanded the federal common law of privilege to incorporate the Delaware rule in situations where the communications arose from a Delaware transaction and the parties expected the communications to be confidential.

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Physiotherapy's Facts

The facts of the case are straightforward. A company's owners sold their shares through a cash-out merger governed by Delaware law. A few years later, the company filed for bankruptcy with a prepackaged plan of reorganization. The plan formed a litigation trust to pursue potential claims. Following confirmation of the plan, the litigation trust sued the former owners, alleging that the payments they received in the sale were intentional and constructive fraudulent transfers under the Bankruptcy Code and state law.

The parties conducted discovery, and the former business owners withheld certain transaction-related communications as privileged. The communications at issue were made at the time of the transaction and

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involved the client, the attorneys and financial advisors. The defendants withheld the communications on the ground that they arose from a Delaware merger and were attorney-client privileged under Delaware's privilege rule. The litigation trust argued that federal privilege law applied, and that the communications had to be produced because the narrower federal rule held that the inclusion of the financial advisors in the communications waived the privilege.

Attorney-Client Privilege Involving Financial Professionals

Delaware law sets forth a clear and broad rule protecting privileged communications with financial advisers. A basic principle of privilege law holds that a third party's presence in an attorney-client privileged communication generally will break the privilege. But Delaware law recognizes that attorneys and clients may need to communicate with financial professionals to properly give and receive legal advice, which frequently occurs in connection with a transaction. Based on this practical reality, a long line of Delaware cases holds that the financial professional's participation in or presence on an attorney-client privileged communication does not waive privilege if the parties expected to treat the communication as confidential. *See*, *e.g.*, *Jedwab v. MGM Grand Hotels, Inc.*, 1986 WL 3426, at 2 (Del. Ch. Mar. 20, 1986); *3Com Corp. v. Diamond II Holdings, Inc.*, 2010 WL 2280734, at 5–6 (Del. Ch. May 31, 2010).

Federal privilege law is not so clear or broad. Surprisingly, there is no uniformly applied test across the federal courts. Some courts ask whether the financial professional is the "functional equivalent" of a client employee, such that it stands in the same shoes vis-à-vis the lawyer as the client. *See*, *e.g.*, *In re Bieter Co.*, 16 F.3d 929, 935–40 (8th Cir. 1994).

Other courts examine the precise role that the financial professional plays

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in the communication, and protect only those communications where the professional "translates" or "interprets" financial material for the lawyer. *See*, *e.g.*, *United States v. Ackert*, 169 F.3d 136, 139–40 (2d Cir. 1999). Moreover, courts applying either test have done so with inconsistent results. In most cases, federal courts have applied the attorney-client privilege involving financial professionals more narrowly than Delaware state courts, as Delaware courts do not require any assessment of the financial professional's precise role in the communication.

Which Law Applies?

Because of this difference in federal and Delaware law, parties to a Delaware transaction may find themselves in a predicament if that transaction is later challenged in federal court, as there is no assurance that a federal court would apply Delaware's privilege law. It is settled law that a federal court will apply federal privilege law to federal causes of action and state privilege law to state causes of action. But if a lawsuit presents both federal *and* state causes of action and the evidence at issue relates to both, then a federal court will apply federal privilege law to the evidence. *See*, *e.g.*, *Pearson v. Miller*, 211 F.3d 57, 66 (3d Cir. 2000).

This generally means that any complaint that includes a federal cause of action will by default lead to the application of federal privilege law, a result that puts parties to a Delaware transaction in an untenable position. On the one hand, Delaware law governs the transaction from which the communications arose, and the parties therefore would expect Delaware privilege law to apply at the time that they actually made the communications. But on the other hand, the parties would have no assurance that if they were hauled into federal court, the court would honor the Delaware state law privilege.

Federal courts have recognized that a federal privilege can be expanded by applying an existing state law privilege. *See*, *Pearson*, 211 F.3d at 67. In deciding whether to recognize a state privilege rule under federal common law, courts consider whether the state's rule promotes "sufficiently important interests to outweigh the need for probative evidence." *Id*.

In other contexts, district courts within the Third Circuit have applied the *Pearson* test and recognized state privilege rules as a matter of federal common law. *See*, *Castellani v. Atlantic City*, Civ. No. 13–5848 (JBS/AMD), 2017 WL 1201755, at 4–6 (D.N.J. Mar. 31, 2017); *KD ex rel. Dieffenbach v. United States*, 715 F. Supp. 2d 587, 592–94 (D. Del. 2010); *Sheldone v. Penn. Turnpike Comm'n*, 104 F. Supp. 2d 511, 515 (W.D. Pa. 2000).

Bankruptcy Court's Ruling In *Physiotherapy*

Parties to a Delaware transaction can now breathe easier in light of the bankruptcy court's recent ruling. The court began its analysis by noting that although federal law governed the dispute, federal privilege law is flexible. The court quoted *Pearson* and noted that the case for recognizing an expanded privilege is stronger if the privilege is recognized by a state, is supported by a strong state interest, and is not outweighed by a countervailing federal interest. *See*, *Pearson*, 211 F.3d at 66. The court found that each of these criteria was met in *Physiotherapy*.

First, Delaware recognizes an expanded privilege for attorney-client communications involving financial professionals. The court noted that the communications involving the financial professionals at issue occurred in the context of their work on the merger, which was governed by Delaware law. Second, the court found that Delaware has an "overwhelming" interest in upholding the expectations of parties who avail themselves of Delaware law in a transaction such as this, including expectations that communications that are privileged when made, will stay that way.

The court noted that the defendants' expectation that Delaware law would apply was "entirely reasonable." Apr. 26, 2018 Hr'g Tr. at 68:20–23. Third, the court found no strong counterveiling federal policy, such as civil rights concerns, that would weigh in favor of applying the narrower federal privilege. The court therefore concluded that, on the facts of the case, the federal attorney-client privilege would be expanded by applying the Delaware rule for communications involving financial professionals.

Thus, the court adopted the rule that "where a financial professional … is retained for purposes of a transaction and assisted the lawyers with the transaction, communications with the financial professional and communications that financial professional has relating to the transaction are protected by privilege." Apr. 26, 2018 Hr'g Tr. at 70:14–19. The court cited with approval the *3Com* and *Jedwab* decisions from the Delaware Court of Chancery and noted that "[w]ithout this protection, clients would not be able to function in the business world because advice would not be protected." *Id*. at 71:4–6.

Implications for Transactional Attorneys

Although several federal courts within the Third Circuit have relied on the same *Pearson* test to recognize other types of state privileges under federal law, the *Physiotherapy* decision appears to be the first to apply that reasoning specifically to expand the attorney-client privilege as it relates to financial professionals.

The court's ruling recognizes that if parties cannot reasonably predict whether communications will be privileged (because a court later might refuse to honor the privilege), then the privilege would be toothless, resulting in the chilling of transactional attorney-client communications and the frustrating of Delaware law.

This decision should provide some comfort to professionals advising on a Delaware transaction that federal courts will honor Delaware's broader privilege rule for transaction-related legal communications involving financial professionals.

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