AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for Today's Busy Insolvency Professional

Who Owns Privileged E-Mails in a §363 Sale Case?

Is Ownership Waived When the Debtor's Computer Servers Are Sold?

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The fact pattern is common. A debtor commences a chapter 11 case to sell its business as a going concern in an expedited process. The purchaser reasonably wants the debtor's servers, backup tapes and other computer systems as part of the sale-acquired assets because the servers are necessary to operate the business and the backup tapes provide the safety net of an archive of a business the buyer might know little about.


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Now, suppose the debtor entered chapter 11 amid allegations—perhaps by securities or stockholder class action plaintiffs, perhaps by the U.S. Securities and Exchange Commission or other governmental entity—that its board or management committed some wrongdoing. Not surprisingly, before the sale, the directors, officers and general counsel used company e-mail accounts to correspond concerning this investigation or litigation. General counsel also had drafted memoranda, PowerPoint presentations and Excel spreadsheets. But in the frenetic pace of the §363 sale, no one stops to consider the attorney-client privilege issues of selling the server and the backup tapes that contain all of this privileged information. The asset-purchase agreement, approved by the bankruptcy court, specifically states that the servers and the backup tape now are owned by the buyer but is silent about who owns their content. Obviously, no one spent the time to delete privileged files and e-mails from the server (and copy them to preserve them for discovery), much less from the backup tapes.

Who "owns" the privilege now—the buyer or the seller? Even if the answer is the debtor/seller, does the fact that a third party now has physical possession of privileged information mean that the privilege has been waived, just like producing a privileged hard copy memorandum to a third party waives privilege in the document, unless the court applies a more liberal "inadvertent disclosure standard?" Moreover, if buyer and seller litigate over an escrow, earnout or holdback—another increasingly frequent scenario—and the litigation turns to an interpretation of the asset purchase agreement, who holds the privilege over the negotiations of the asset-purchase agreement?

Given how frequently this fact pattern has occurred in recent bankruptcy cases, it might surprise you to learn that there is almost no case law answering these questions. Thus, the Delaware Court of Chancery's little-noticed February 2008 opinion in *Postorivo v. AG Paintball Holdings Inc.*,[1] which, applying New York law,[2] tackles some (but not all) of these issues in a nonbankruptcy setting, takes on increased importance. Of particular note is that *Postorivo* holds that parties may contract around many of these privilege issues, so practitioners should consider addressing them in future asset-purchase agreements in §363 sale cases.

Background of *Postorivo*

Postorivo involved a suit between a buyer and seller outside of bankruptcy. This opinion resolved which party holds the attorney-client privilege with respect to communications that took place before and after the consummation of the asset purchase agreement (APA) that impact the operations of the post-APA entity, communications concerning the APA itself and communications about assets and liabilities that were specifically excluded from the sale in the APA.

The company at issue was National Paintball Supply Inc. (NPS), a corporation owned by Eugenio Postorivo that sold paintball gaming items. After experiencing financial decline, NPS sold substantially all of its assets, including its computer systems and servers, to AJ Intermediate Holdings Inc. (AJI). AJI then rolled the NPS assets, along with the assets of another paintball gaming company, into KEE Action Sports Holdings Inc. and continues to operate as a paintball supply company. Under the terms of the APA, NPS retained certain assets and liabilities, including litigation claims

Beyond the Quill

1 C.A. Nos. 2991-VCP and 3111-VCP, 2008 WL 343856 (Del. Ch. Feb. 7, 2008).

2 The court applied New York law because the contract stipulated a choice of New York law and New York had the most significant relationship to the proceedings. Likewise, if such a suit is litigated in bankruptcy court and state law supplies the rule of decision, the court would apply state privilege law. See Fed. R. Evid. 501. Given how many contracts provide for application of New York law, Postorivo provides welcome guidance on these issues.

against two companies referred to as the "procaps litigation."

After the transaction closed, relations soured between the parties and culminated in the sellers suing the buyer. Recognizing their unusual position of having their privileged e-mails and communications in the hands of their litigation opponents because the computer servers were sold with the other assets, the sellers filed a discovery motion, seeking a ruling that they still controlled the attorney-client privileges despite the sale.

Legal Issues Raised in *Postorivo*

While the parties originally contested all three issues listed above, the first two settled: The parties agreed that the buyer holds the privilege for even presale communications about operations, but the seller controls the privilege for communications about the APA negotiation itself. While the court could have just reported that agreement, it went out of its way to state that it concurred with the agreement and explained its reasons why. Given that these are recurring issues, the court's rationale on even the "settled" issues is welcomed.

Privilege Relating to Operations

The court confirmed that the buyer holds the attorney-client privilege with respect to communications about the operations of NPS because, under *Tekni-Plex Inc. v. Meyner & Landis*,[3] when a successor entity continues to operate a predecessor, the successor "stands in the shoes of prior management and holds the privilege with respect to communications regarding the company's operations."[4] According to the court, KEE Action acquired NPS and continued to operate the business, so it was up to NPS management to assert the attorney-client privilege for matters relating to the company's operations.[5] Notably, KEE Action was operating a very different company, because it merged the NPS assets with those of another paintball supply company, but the issue was not raised by the court, presumably because the issue had been settled.

Privilege Concerning the Negotiation of the Transaction

In confirming that only the sellers hold the attorney-client privilege for communications concerning the transaction itself and the APA, the court cited *Tekni-Plex's* holding that where a transaction is negotiated by adverse parties, a buyer cannot pursue its rights as a purchaser and claim to hold the attorney-client privilege rights of the seller.[6] Because Postorivo and NPS were adverse in negotiating the APA (a fact that presumably always would be the case), the court reasoned that their rights relating to disputes arising from the APA itself were adverse to, and independent of, the rights of each other. KEE Action did not acquire NPS's rights with respect to communications regarding the APA transaction.[7]

Privilege over Communications Concerning Excluded Assets

The court held that the sellers hold the attorney-client privilege for communications concerning the excluded assets and liabilities. It reasoned that holding otherwise would cause NPS to defend liabilities and prosecute the procaps litigation without being able to assert or waive attorney-client privilege—a result that the court noted was impractical.[8] The court also cited APA language that seemed to indicate that the parties agreed that NPS would retain the attorney-client privilege as related to the procaps litigation.[9] In doing so, the court rejected an argument under *American International Specialty Lines Ins. Co. v. NWI-I Inc.*[10] that the privilege should lie with the buyer because privilege is not something that can be divided between parties, even if the contract stated otherwise.[11] The court held that the contract does govern and may provide who holds the privilege, even if that means that the privilege will be "divided," *i.e.,* that the sellers retain privilege for certain issues and the buyer acquires it for others. In so ruling, the court distinguished—and, to the extent not distinguishable, declined to follow—*American International*.

No Waiver of Privilege

In a footnote, the court rejected an argument that the sellers waived all privilege that the sellers retained because the documents were actually in the buyer's possession on the transferred computer server. Using language suggestive of the "inadvertent production" standard for producing paper documents in litigation, the court held that no "reasonable inference" could be drawn that NPS and Postorivo "deliberately and voluntarily" surrendered attorney-client privilege.[12] To support this finding, the court pointed to the way the sellers and their counsel "conducted their affairs after the APA closed,"[13] without describing what conduct led the court to conclude they did not intend to waive privilege.

Should the Court Have Found No Waiver of the Privilege?

This last point—that whatever privilege remained with the sellers was not waived even though the communications were located on a computer server in the physical possession of the buyer and not the seller—is not without controversy. In the world of paper, turning over a document to a third party typically *does* constitute a waiver.[14] Privilege law is based on confidentiality; if an otherwise privileged communications is not made in confidence, the privilege does not attach.[15] "The disclosure rule operates as a corollary to this principle: If a client subsequently shares a privileged communication with a third party, then it is no longer confidential, and the privilege ceases to protect it."[16] Thus, under the traditional approach to waiver of the attorney-client privilege, even the inadvertent production of documents waives the privilege and, taken to its logical extreme, even a document in a stolen car would lose its privilege.[17] Other courts have rejected this extreme view, holding that the "mere inadvertent production of documents...does not waive the privilege."[18] Under this contemporary view, courts engage in a fact-specific inquiry to determine whether there was an intention to disclose the documents or

3 89 N.Y. 2d. 123 (N.Y. 1996).
4 *Postorivo*, 2008 WL 343856 at *5.
5 *Id.*
6 *Id.*
7 *Id.* at *6.
8 *See id.* at *8.
9 *Id.*
10 240 F.R.D. 401 (N.D. Ill. 2007).
11 *Postorivo*, 2008 WL 343856 at *6.
12 *See id.* at fn.13.
13 *Id.*
14 *See, e.g., Teleglobe USA Inc. v. BCE Inc. (In re Teleglobe Commc'ns. Corp.),* 493 F.3d 345, 361 (3d Cir. 2007) ("Disclosing a communication to a third party unquestionably waives the [attorney-client] privilege.").
15 *Id.* (citing *Restatement (Third) of the Law Governing Lawyers* §68 (2000)).
16 *Id.*
17 *See, e.g., Berg Elecs. Inc. v. Molex Inc.,* 875 F. Supp. 261, 262 (D. Del. 1995) (explaining that, under the traditional approach "[t]he privilege for confidential communications can be lost if papers are in a car that is stolen, a briefcase that is lost, a letter that is misdelivered, or in a facsimile that is missent"); 8 John H. Wigmore, Evidence §2325, at 633 (McNaughton rev. 1961) ("All involuntary disclosures, in particular, through the loss or theft of documents from the attorney's possession, are not protected by the privilege, on the principle...that, since the law has granted secrecy so far as its own process goes, it leaves to the client and attorney to take measures of caution sufficient to prevent being overheard by third persons. The risk of insufficient precautions is upon the client. This principle applies equally to documents.")
18 *Berg Elecs. Inc.,* 875 F. Supp. at 263 (citing *Helman v. Murry's Steaks Inc.,* 728 F. Supp. 1099, 1104 (D. Del. 1990)); *Fidelity Bank N.A. v. Bass,* 1989 WL 9354 (E.D. Pa. Feb. 8, 1989); *Mendenhall v. Barber-Greene Co.,* 531 F. Supp. 951, 954-55 (N.D. Ill. 1982)).

communications, whether such disclosure was merely inadvertent and even if the disclosure was unintentional, whether it was "so negligent or reckless that the court should deem it intentional."[19]

While not articulating its reasons other than saying that the "circumstances" and the way the sellers "conducted their affairs after the APA closed" indicated no "deliberate and voluntary" waiver of privilege,[20] the *Postorivo* court appears to have applied the contemporary view on inadvertent production. However, it is not clear that the standard applied inadvertently producing a hard copy document in a litigation should be used for the wholesale turnover of a computer server and all of its contents. Moreover, even if that is the correct standard to apply, it is far from clear that it was applied correctly. While the sellers likely never intended to disclose privileged documents, the sellers certainly did intend to transfer physical possession of the only copy of their server to the buyer and did not attempt to purge privileged communications contained on the server. Presumably, the sellers simply never thought about the subject, because had they done so, they must have known that privileged communications, such as e-mails, Word documents, PowerPoints and Excel spreadsheets, remained on the server. Given that the standard is not only actual knowledge but whether the seller was "so negligent or reckless that the court should deem it intentional,"[21] one has to wonder whether, in future cases, litigants will argue that selling a server with no purging of privilege from the hardware (while retaining copies for litigation) and no protections in the APA is in fact "negligent or reckless."

In the meantime, in the fast-paced world of §363 sales, this holding is welcome news to debtors, who likely rarely think about this subject in the rush to complete a deal. But it is unclear whether future opinions will agree with a footnote ruling in *Postorivo*, even if it is the only case to date addressing the point.

Seller Controls Privilege over Excluded Assets and Liabilities

Likewise, it will be welcomed news to debtors that they continue to control the privilege over excluded assets and liabilities. Because purchasers in §363 sales rarely assume any liabilities other than cure claims for assigned contracts, most liabilities are typically excluded. The hypothetical above about the government investigating or stockholder plaintiffs suing for alleged wrongdoing of the company and its board and management would nearly always concern an excluded liability, and the debtor/seller would maintain the privilege (and any common interest or joint client privilege with the directors and officers (D&Os)). In addition, the debtor's claims *against* D&Os usually are excluded assets, and any privilege in communications about such claims should remain with the debtor/seller under *Postorivo*.

However, there are gray areas here as well. Most litigation in some way relates to the company's operations, and the *Postorivo* court held that privilege in communications relating to operations belongs to the buyer, not the seller. Suppose a company is being investigated by the government or is in litigation about its prepetition billing practices. Certainly that relates to operations and might well be something the buyer is interested in, so it might argue that under *Postorivo's* "operations" holding, the buyer controls the privilege. Yet surely any claims against the debtor relating to prior billing practices will be an excluded liability, so the seller presumably would argue that it controls the privilege under the "excluded assets and liabilities" holding in *Postorivo*. Thus, while it is a welcomed development to have a case like *Postorivo* fill some voids in the law, we will have to await further refinement in the case law before some of the thornier issues are resolved.

> While Postorivo is one of the first cases addressing who owns the privilege in these scenarios, it will not be the last.

Freedom of Contract

Perhaps the most important holding of *Postorivo* is that courts will respect the APA if it addresses privilege issues[22]—apparently a point that was very much in dispute.[23] Thus, the best way to address the problems described herein is to specifically address them in the APA.

Of course, that often is easier said than done. It should not be difficult to craft provisions that state who owns the privilege as to various categories of electronic documents. The bigger problem is whether you can contract around a finding of waiver (so as not to have to rely on the footnote in *Postorivo*), given that the electronic documents will be in the possession of the buyer once the computer server is transferred. The author suggests providing in the APA that notwithstanding the transfer of the server, the buyer shall not actively search for electronic documents that contain a privilege that the seller is retaining, and that if the buyer accidentally accesses any such pretransfer privileged document, it shall not read it and instead shall immediately delete it or provide a copy to the seller. While no case has confirmed that such a provision will have effect, its existence presumably should have some weight in the analysis of whether the seller intended to disclose the documents and waive privilege.

Similarly, selling debtors should strongly consider insisting that the sale of servers and backup tapes be conditioned on the court entering, as part of the sale order, language pursuant to newly adopted Federal Rule of Evidence 502(d). This states that "a [f]ederal court may order that the privilege or protection is not waived by disclosure connected with the litigation pending before the court—in which event the disclosure is also not a waiver in any other [f]ederal or [s]tate proceeding." Rule 502(d) was adopted for a different purpose: to permit the use of "quick peak" provisions in discovery. But the policy behind it (the onerous costs associated with privilege review of electronically stored information), as well as the literal words, seem to indicate it could provide some protection to a debtor/seller in a §363 sale if the language is contained in the order approving the sale. Given that 502(d) is a Rule of Evidence, and with its use of the word "litigation" rather than "proceeding," there are no assurances that courts would apply Rule 502(d) in this context. One thing is certain: If a debtor/seller intends to rely on Rule 502(d), it should get the language in the sale order, not merely the asset-purchase agreement,

19 *See supra* fn. 17.
20 *Postorivo*, 2008 WL 343856 at *4 n.13.
21 *Berg Elecs.*, 875 F.Supp. at 263.
22 *Postorivo*, 2008 WL 343856 at * 6.
23 *See id.* at *7.

because "an agreement on the effect of disclosure in a [f]ederal proceeding is binding only on the parties to the agreement, unless it is incorporated into a court order." Fed. R. Evid. 502(e).

Conclusion

One thing is for certain: While *Postorivo* is one of the first cases addressing who owns the privilege in these scenarios, it will not be the last. In a world where 90 percent of the important documents in discovery are electronically stored information, and in an environment where asset sales are far more common than true debt-to-equity reorganizations, this issue undoubtedly will recur. We will have to await further developments in the case law to have certainty on many issues.

Until then, debtors' counsel should strongly consider addressing these points in the asset-purchase agreement. Indeed, who will retain the privilege, as to what, and how to deal with privileged e-mails and other documents on servers and backup tapes being sold should be a part of most "checklists" in negotiating an asset purchase agreement. ■

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