PetSmart Tells PE Firms to GetSmart on Privilege
How PE firms can minimize attorney-client privilege risks after Argos Holdings Inc. and PetSmart Inc. v. Wilmington Trust N.A.

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TAKEAWAYS

PE firms face a variety of litigation and deal-related attorney-client privilege challenges which can be minimized with a thoughtful approach to training and structure.

Argos makes clear that PE firms should pay close attention to attorney-client privilege issues involving their board designees.

PE firms should ensure that portfolio companies have guidelines in place to preserve attorney-client privilege and ensure outside counsel is aware of these dynamics.

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Much like our beloved pets provide us with ill-timed wake-up calls, a federal court in the Southern District of New York recently provided private equity firms with a reminder not to hit the snooze button when it comes to protecting attorney-client privilege in the context of designated directors serving on the boards of directors of portfolio companies. On March 28, 2019, the District Court, in Argos Holdings Inc. and PetSmart Inc. v. Wilmington Trust N.A., ruled largely in favor of defendants in compelling the plaintiffs to produce allegedly privileged documents that had been sent by law firms representing PetSmart and its owner directly to three individuals who were partners at a private equity firm which was one of the company’s major investors. We discuss below why this case is of interest to private equity firms that appoint their employees as directors to portfolio company boards, along with other attorney-client privilege concerns and practical tips.
Attorney-Client Privilege—A Quick Primer

The attorney-client privilege is the oldest among the common-law evidentiary privileges and protects confidential communications between a client and its attorney made for the purpose of obtaining or providing legal advice. The purpose of the privilege is to encourage full and frank dialogue between lawyers and clients, and communications protected by the privilege need not be disclosed in litigation. *Upjohn Co. v. United States*, 449 U.S. 383, 389, 101 S. Ct. 677, 682, 66 L. Ed. 2d 584 (1981). It is important to keep in mind that courts’ analyses of the attorney-client privilege vary according to state and there can be significant, and outcome-determinative, differences among states. We provide a general overview of key principles associated with the privilege as well as those principles’ application within the private equity context.

To be privileged, a communication essentially must be primarily or predominantly of a legal—rather than a business—character. The critical inquiry is whether the communication was made in order to render legal advice or services to the client. *Spectrum Sys. Int’l Corp. v. Chem. Bank*, 78 N.Y.2d 371, 377, 581 N.E.2d 1055, 1059 (1991). Courts generally tend to scrutinize more closely communications with in-house counsel than outside counsel—guided by the principle that the privilege is not meant to be used as a shield to protect otherwise discoverable information. This is due primarily to the fact that in-house lawyers often have mixed legal and business responsibilities and can wear multiple hats, including serving as company officers. During their day-to-day interactions, in-house lawyers often walk the line between legal and nonlegal involvement in company affairs—and that line can easily, and inadvertently, get blurred. Courts have warned that the mere participation of an in-house lawyer does not automatically protect communications from disclosure. *Rossi v. Blue Cross & Blue Shield of Greater N.Y.*, 73 N.Y.2d 588, 594, 540 N.E.2d 703, 705-706 (1989).

Privilege Challenges Facing In-House Counsel

In the private equity context, issues relating to the attorney-client privilege may arise in various scenarios, including when: (1) a private equity firm’s employee plays multiple roles, (2) one lawyer or law firm represents two clients, (3) clients share a common legal interest, and (4) there is a sale of a portfolio company.

Multiple Roles of Private Equity Professionals

Private equity firms commonly designate employees to serve as members of the boards of directors of portfolio companies. These designees wear two hats—one as employees of the private equity firm and the other as members of portfolio companies’ board of directors. If a portfolio company shares privileged information (e.g., advice provided by the portfolio company’s outside or in-house counsel) with an individual in his capacity as a director, the attorney-client privilege should be preserved. However, if the privileged information is shared with an individual other than in his capacity as a director, or if that individual subsequently shares the privileged communication with his private equity colleagues in his capacity as an employee of the private equity firm, there is a risk that the attorney-client privilege could be considered to have been waived. (Generally, when a client shares privileged information with a third party, the attorney-client privilege will be
waived.) As *Argos Holdings* teaches, in addition to being trained with respect to fiduciary duties owed to portfolio companies, private equity director designees should be sensitized to the issue of preserving portfolio companies’ privilege.

In *Argos Holdings*, a private equity firm invested in Argos Holdings Inc. and appointed three of its own employees to the Argos board of directors (which had seven directors in total). *Argos Holdings Inc. v. Wilmington Trust Nat'l Ass'n*, No. 18cv5773 (DLC), 2019 WL 197150, at *1 (S.D.N.Y. Mar. 28, 2019). Argos, through its subsidiary, had retained outside counsel to help it acquire PetSmart, an online pet supply retailer, and issues arose with an administrative agent during the acquisition. After the administrative agent refused to release the liens it held on the target company’s assets, litigation ensued. During the discovery phase, Argos moved for a protective order with respect to thirteen sets of documents, ten of which the Court found were not privileged. See id. at *2.

The Court relied on a few key facts in making its determination. First, the Court found that the ten sets of documents were sent by outside counsel to the three private equity-designated board members, but not the rest of the Argos board. See id. at *4. Second, Argos failed to describe any measures taken to prevent disclosure to the private equity firm of privileged communications with Argos personnel, officers or directors. See id. at *5. Third, despite the three private equity board members having email addresses at the portfolio company, the documents at issue were sent to their private equity firm email addresses and thus were stored on the private equity firm’s email servers. See id. Because Argos was unable to demonstrate that the three private equity board members received these communications pursuant to their status as directors at Argos, the Court held that the attorney-client privilege was waived. See id.

**Joint-Client Theory**

The joint-client or co-client theory applies when one attorney represents the interests of two or more entities on the same matter, including where a parent corporation and one of its subsidiaries consult the same counsel with respect to a common legal cause. See, e.g., *Bass Pub. Ltd. Co. v. Promus Cos. Inc.*, 868 F. Supp. 615 (S.D.N.Y. 1994). Each respective joint client’s communications with common counsel are protected by the attorney-client privilege, and if such communications are shared with another joint client, the privilege should be preserved.\(^1\) Whether two clients qualify as joint clients depends primarily on the understanding of the parties and the lawyer in light of the circumstances, including the details of the representations and the clients’ interaction with the attorney and each other. *In re Teleglobe Communications Corp.*, 493 F.3d 345, 363 (3d Cir. 2007), as amended (Oct. 12, 2007)) (citing *Sky Valley Ltd. P’ship v. ATX Sky Valley Ltd.*, 150 F.R.D. 648, 652-53 (N.D. Cal. 1993)).

There is not well-developed case law applying joint-client principles to the private equity context (i.e., to communications between a private equity firm and a portfolio company that shares the same lawyer). Accordingly, it is important to proceed with caution when relying on the joint-client theory and make clear in engagement letters with outside counsel that such representation will be on a joint-client basis.
Common Interest Exception

Common interest is an exception to the general rule that the presence of a third party will destroy a claim of privilege. Where two or more clients separately engage their own counsel to advise them on matters of common legal interest, the common interest exception allows them to shield from disclosure certain attorney-client communications that are revealed to one another for the purpose of furthering a common legal interest. This exception historically has been applied in the merger context. For instance, where parties were represented by separate counsel and a merger agreement directed them to share privileged information relating to preclosing legal issues, courts generally had found that such disclosure did not waive the privilege—reasoning that the parties shared a common legal interest and the communication was designed to further that interest. However, in Ambac Assurance Corp. v. Countrywide Home Loans Inc., the New York Court of Appeals held that such a fact pattern would waive the attorney-client privilege, unless the sharing of information was made in connection with pending or reasonably anticipated litigation. 27 N.Y.3d 616 57 N.E.3d 30 (2016). Making matters even more complicated is that those jurisdictions requiring a litigation element differ on whether litigation must be pending or only reasonably anticipated. Accordingly, in-house counsel should use caution and anticipate that the common interest exception may not apply to these types of communications (especially considering the recent uptick in merger-related lawsuits).

The common interest exception also may apply in the context of a communication between the private equity firm and its investors concerning a threatened or ongoing litigation or investigation. Much like communications including portfolio companies, these interactions require careful analysis due to the risk of waiver (i.e., the potential that the private equity firm loses the privilege by sharing privileged information with one or more limited partners). The District Court addressed this issue in Argos Holdings—specifically, the Court found that the common interest doctrine was inapplicable because Argos did not assert that its outside counsel was acting as the private equity firm’s counsel in connection with the acquisition of the target company. See 2019 WL 1971450, at *7.

Sale of a Portfolio Company

When control of a company passes to new management, whether through a sale, merger, takeover or normal succession, the authority to assert and waive the company’s attorney-client privilege also passes to new management. Bass Pub. Ltd., 868 F. Supp. at 619 (citing Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 343, 349, 105 S. Ct. 1986, 1991, 85 L.Ed.2d 372 (1985)). If a company that acquires a portfolio company from a private equity firm later sues the private equity firm, the acquirer may be able to access and use in the litigation legal advice that the private equity firm and its former portfolio company received jointly. Thus, it is important to limit the joint representation of a private equity firm and its portfolio companies to instances in which it is necessary. And, consideration should be given to whether it makes sense to retain separate counsel for purposes of any contemplated sales/purchases in an effort to limit the amount of privileged communication that can be passed to new management.
Practice Tips and Lessons Learned

*Argos Holdings* provides private equity firms with somewhat of a roadmap (at least in New York) to preserve the attorney-client privilege. While privileged communications are not likely to be challenged until litigation, it is important to follow best practices to ensure that the firm and its portfolio companies are in a strong position to defend the privileged status of their communications. Think about the extent to which the privilege may or may not apply to a particular communication with a portfolio company or a fund investor.

- **No Bright-Line Test.** As the District Court noted in *Argos Holdings*, there is no established test to assess the capacity in which communications were received where the recipient has multiple roles in a transaction. However, the court offered guidelines to help prevent these communications from being disclosed during litigation—e.g., establishing procedures governing private equity directors’ ability to share with the sponsor communications between the directors and attorneys representing the portfolio company’s board.

- **Make Any Joint-Client Relationship Clear in an Engagement Letter.** When the joint-client theory is a portfolio company’s basis for asserting that sharing privileged information with a private equity firm does not waive privilege, such expectation should be laid out in an engagement letter with the law firm that clearly sets out the scope of the joint representation. Further, agreements between the private equity firm and its portfolio company should provide that privileged information will be shared among the parties as co-clients and must be kept confidential and not shared with any third parties.

- **Keep Those with Multiple Roles Aware of the Risk.** Educate employees who serve as designees on boards of portfolio companies of the risks associated with sharing privileged information belonging to the portfolio company with others at the private equity firm. If applicable, remind the employees serving in two roles to communicate with outside portfolio company counsel through their email addresses at the portfolio company, as opposed to their private equity firm email addresses.

- **Establish Guidelines to Maintain Confidentiality.** The portfolio company should have guidelines set in place that prevent the directors from sharing communications between themselves and outside counsel with the private equity firm. Note that private equity board designees may also have a duty to share information with their fund for purposes of understanding the investment, which raises issues regarding steps to maintain confidentiality.

- **Ensure Outside Counsel is Aware of this Risk.** When retaining outside counsel, make sure that they are aware of the directors’ status within the portfolio company and the private equity firm. Outside counsel should be aware of these issues so that they do not inadvertently waive privilege by disclosing information to private equity firm employees.

- **Take Steps to Maintain Privilege.** When possible, disseminate privileged information only to those who “need to know,” (i.e., those who need to know the content of the communication to perform their job effectively or to make informed decisions concerning the subject matter of the legal communication). Instruct those with access to privileged information to avoid disclosing such information to others.
As Argos teaches us, by taking care to properly identify privileged communications and implement thoughtful policies and procedures, private equity firms should be able to successfully balance minimizing the risk of waiver with the commercial goal of effectively managing its investments.

1. Waiving the joint-client privilege typically requires the consent of all joint clients. A joint client may unilaterally waive the privilege as to its own attorney-client communications, so long as those communications concern only the waiving client. Such client may not unilaterally waive the privilege as to any of the other joint clients’ communications or as to any of its communications that relate to other joint clients. In re Teleglobe Communications Corp., 493 F.3d 345, 363 (3d Cir. 2007), as amended (Oct. 12, 2007).

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