

Protecting Privilege In Case Of A Dispute With Former Director

By **John Stigi, Alejandro Moreno and Eugene Choi** (April 14, 2023)

Providing legal advice to business entities raises important issues regarding the application of attorney-client privilege between the entity and its directors. Delaware's approach to corporate privilege springs from the recognition that corporate directors and the corporation they control are deemed "joint clients" of legal advice received while the directors form part of the board.



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As a result, in the event of litigation, a former director is presumptively entitled to obtain privileged materials created during that director's tenure on the corporation's board. By default, Delaware's joint-client approach to corporate privilege allows other entities with whom such former director may be affiliated to access privileged materials.



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A March decision by the Delaware Court of Chancery, *Hyde Park Venture Partners Fund III LP v. FairXchange LLC*, provides a useful road map to the joint-client approach to privilege.

FairXchange Inc. had a three-person board of directors, one of whom was also was a partner in a venture capital firm that managed several funds, which invested in the company.

FairXchange received an acquisition proposal from Coinbase Global Inc. The director appointed by the investor favored exploring FairXchange's strategic alternatives, while the remaining two directors favored selling the company to Coinbase.



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These two directors ultimately sidelined the director appointed by the investor and secured shareholder approval to remove him from the board. The new board ultimately approved the merger with the buyer.

After the merger, the investor initiated appraisal proceedings under Section 262 of the Delaware General Corporation Law. In discovery, the investor demanded information created during its director's tenure on the FairXchange's board of directors. The company resisted these requests, asserting attorney-client privilege as to materials involving its outside counsel.

The Court of Chancery applied the joint-client approach to privilege and rejected the company's privilege position:

The bottom line for the attorney-client privilege is that under the joint client approach, the investor presumptively joins the director within the circle of confidentiality, and the corporation cannot invoke the privilege against the investor for materials created during the director's tenure.

As the Court of Chancery aptly noted, humans have but one brain. Information sharing necessarily happens when a corporate director represents an outside investor. Indeed, such information sharing is expected and is to be presumed.

In this article, we summarize Delaware's approach to corporate privilege and provide a few practical tips on how to reduce the risk that a former director — or an entity affiliated with that director — will be granted access to sensitive privileged materials in the event of litigation.

Delaware's Joint-Client Approach to Corporate Privilege

Under Delaware law, litigants are entitled to "obtain discovery regarding any non-privileged matter that is relevant to any party's claim or defense and proportional to the needs of the case." Thus, a matter must be nonprivileged before it is deemed discoverable.

In Delaware, the attorney-client privilege extends to: (1) communications, (2) which are confidential, (3) which were made for the purpose of facilitating the rendition of professional legal services to the client, (4) between the client and its attorney.

Corporate records created during a director's tenure on the board are presumptively not privileged vis-à-vis individual directors because the corporation has no expectation that any such records would be kept "confidential" from its directors. After all, the directors of a Delaware corporation have expansive rights to access nearly all corporate records. Moreover, the board of directors has ultimate authority to control a corporation.

The lack of confidentiality and the fact that a corporation acts through its directors render the corporation and its directors "joint clients" with respect to advice received during the directors' service to the corporation.

Under Delaware law, there is no privilege between joint clients as to matters of common interest between them. Accordingly, former directors are presumptively entitled to access privileged materials created during their tenure on a corporate board.

Directors With Dual Loyalties

As was the case in *FairXchange*, it is common for corporate directors to represent different interests on a company's board of directors.

On occasion, such directors may have conflicting loyalties.

For example, outside investors many times obtain a right to nominate a director in exchange for providing financing to a company. Under these circumstances, the investor nominee is both a fiduciary of the entity where he or she serves as a director and a representative of the investor.

This "dual fiduciary" problem can give rise to a host of thorny issues. But as to confidentiality, generally, a director that serves as the nominee of an outside entity is not required to keep corporate information learned during his or her directorship confidential.

For this reason, an outside entity with director appointment rights is within the circle of confidentiality with respect to legal advice received by the corporation and, in the event of litigation against the corporation, it may be entitled to obtain privileged information created during its nominee's tenure on the board.

Affirmative Steps to Withhold Privileged Materials Created During a Director's Tenure on the Board

Delaware law recognizes three paths to protect corporate privilege against a former director.

First, the parties can alter expectations of privacy through contract by, for example, entering into a confidentiality agreement.

These sorts of agreements are relatively common and may be structured to expressly prohibit a director from disclosing certain specifically identified information outside the company. Confidentiality is particularly valuable when a company is in the process of evaluating strategic alternatives.

Companies should consider entering into such agreements with their directors when evaluating a proposed strategic transaction or discussing other sensitive topics. For practical reasons, a company should request a confidentiality agreement early in a director's tenure and before the disclosure of the information requiring confidentiality.

Second, if there is already a significant difference in opinion on the board or the need for confidentiality is paramount, the board can create a special committee pursuant to Delaware General Corporation Law Section 141(c) that excludes some portion of the board.

The special committee can then retain and consult confidentially with counsel and assert privilege against any directors who are not members of the committee regarding those consultations. The special committee must be created openly with full board knowledge. However, the board has broad discretion to create such committees where warranted.

Third, a corporation may assert privilege as to a director where there is sufficient adversity of interests between the corporation and the affected director, and the adversity is communicated to the director.

This exception applies because a director cannot reasonably rely upon corporate counsel with respect to matters on which the corporation and the director are adverse. The director's actual knowledge of the adversity is required. It is not enough that the director merely has a sense that he or she is being excluded from conversations.

This third exception is not as clear-cut as obtaining a confidentiality agreement or forming a special committee because the privilege determination will turn on whether the director and the corporation were actually adverse with respect to the issue at hand. Thus, if there is the potential for adversity, either of the options set forth above are preferable.

Corporate Privilege Is Complicated and Contains Traps for the Unwary

This article examines corporate privilege under Delaware law and provides various strategies to protect corporate privilege with respect to former directors.

It is important to note, however, that not all jurisdictions employ the joint-client approach to corporate privilege.

For example, certain federal precedent employs the so-called "entity approach" to privilege. Under this approach, the entity is the holder of the privilege, and former directors cannot access privileged materials created during their tenure as directors over the objections of

the current management of the corporation.

Although the rationale behind the entity approach for privilege is beyond the scope of this article, it highlights the importance that choice of forum plays with respect to the outcome of privilege issues arising in corporate litigation.

Where there is uncertainty, it is advisable to follow the prophylactic measures allowed under joint-client approach to privilege to maximize the odds that sensitive information can remain privileged with respect to particular directors.

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[1] Hyde Park Venture Partners Fund III LP v. FairXchange LLC, No. 2022-0344 (Del. Ch. Mar. 9, 2023) (Laster, V.C.)