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ATTORNEY-CLIENT PRIVILEGE

SDNY: In Absence of Attorney-Client Relationship, Communications With Consultants Who Happen to Be Attorneys Are Not Protected

By Vincent Pitaro, *Hedge Fund Law Report*

Advisers that think that their communications with attorneys at compliance consulting firms are protected by the attorney-client privilege had better think twice. The U.S. District Court for the Southern District of New York (Court) recently ruled in *SEC v. Benjamin Alderson and Bradley Hamilton* that communications between investment adviser Brite Advisors USA, Inc., known at relevant times as deVere USA, Inc. (DVU), and staff attorneys at its compliance consulting firm, MarketCounsel, LLC (MarketCounsel), were not privileged when made within the scope of a "membership agreement" that specifically disclaimed that the consultant's attorneys were rendering legal advice. DVU also waived privilege by sending an otherwise privileged tax opinion to its accountants without implementing appropriate safeguards.

This article details the background of the litigation, DVU's privilege claims and the Court's opinion and order (Order); provides insight on the implication of the decision for private fund managers from a securities litigation attorney; and outlines several best practices that fund managers should consider in order to avoid waiving privilege.

See our three-part series on protecting attorney-client privilege and attorney work product while cooperating with the government: "Establishing Privilege and Work Product in an Investigation" (Mar. 23, 2017); "Minimizing Cooperation Risks" (Mar. 30, 2017); and "Implications for Collateral Litigation" (Apr. 6, 2017).

SEC Litigation Against DVU Personnel

At relevant times, DVU was registered with the SEC as an investment adviser and had its principal place of business in New York. Its clients consisted primarily of British nationals who resided in the U.S.

In June 2018, the SEC filed a civil complaint (Complaint) against DVU CEO Benjamin Alderson and Bradley Hamilton, a DVU area manager. The SEC alleged that the defendants had violated the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940 in connection with recommendations by DVU to its clients that it withdraw the cash value of their pensions in the U.K. and transfer

the money to an offshore pension plan, known as a Qualifying Recognized Overseas Pension Schemes (QROPS).

The SEC alleged that defendants, who advised clients to transfer their U.K. pensions to Malta-based QROPS:

- failed to disclose to clients all of the compensation they received when a client moved his or her pension to a QROPS, including, most egregiously, half of the 7-percent commission that each client paid to a DVU affiliate on the amount transferred;
- misrepresented the extent of the investment options available through the QROPS; and
- misrepresented the potential U.S. tax consequences of transferring their pensions to a QROPS.

Inadequate or misleading disclosure regarding an adviser's compensation is a common source of SEC enforcement action. See "SEC Sanctions Adviser That Failed to Disclose Sufficient Information About Its Conflicts of Interest in Recommending Wrap Fee Programs to Clients" (Oct. 11, 2018); and "SEC Continues Scrutiny of Undisclosed Fees at Fund Managers" (Jun. 7, 2018).

Advice-of-Counsel Defense

Each defendant claimed, as an affirmative defense to the Complaint, that he had relied in good faith on the advice of counsel. During its examination of DVU prior to commencing the litigation against the defendants, the SEC submitted to DVU a number of requests for information. DVU, however, asserted that certain documents and communications relevant to that defense were protected from disclosure by the attorney-client privilege or the attorney work-product doctrine, including:

- forty-seven communications between DVU and MarketCounsel, most of which concerned DVU's requests for advice on the pending SEC exam and drafts of responses to SEC requests for information; and
- a 2011 tax opinion and a 2013 supplemental opinion (together, Tax Opinion) issued by DVU's outside counsel, Carlton Fields, as to whether transfers of U.K. pension assets to QROPS would generate U.S.-taxable income.

See "Understanding the Wells Process: SEC Enforcement Staff Views of the Process (Part Two of Three)" (Jun. 20, 2019).

Communications With MarketCounsel Are Not Privileged

Confidential communications between an attorney and client for the purpose of seeking or rendering legal advice are generally protected from disclosure by the attorney-client privilege. In addition, under the work-product doctrine, documents prepared by counsel may be protected from disclosure when they are prepared because of the prospect of litigation.

For more on the privilege, see "When and How Attorney-Client Privilege Applies to Communications With In-House Counsel" (Jun. 22, 2017).

MarketCounsel and Affiliated Law Firm Share Attorneys

MarketCounsel was co-founded by attorney Brian Hamburger, who also founded the Hamburger Law Firm (Law Firm), a traditional law firm that charges clients for legal representation and legal advice. In contrast to the Law Firm, MarketCounsel, which happens to employ the same attorneys as the Law Firm, "offers membership packages with varying levels of compliance-related services other than legal representation and advice," according to the Court.

DVU retained MarketCounsel in 2012 to assist it with complying with federal securities laws. In October 2014, around the time that the SEC began an examination of DVU, DVU renewed its consulting arrangement with MarketCounsel. DVU, however, never retained the Law Firm. It was around this time that the SEC submitted the requests for information at issue to DVU.

The "theoretical line" between the legal services offered by the Law Firm and the compliance consulting services offered by MarketCounsel was blurred for two reasons, the Court said. First, the same attorneys worked for both MarketCounsel and the Law Firm. Second, MarketCounsel promoted its services by "emphasizing the legal experience of its compliance personnel."

The only issue before the Court was whether "DVU and MarketCounsel's consultants, who happen to be attorneys, had a relationship that could give rise to attorney-client privilege." The Court determined that they did not because, with one exception, "DVU could not have reasonably believed that MarketCounsel's compliance professionals were acting as attorneys."

MarketCounsel's Disclaimers Regarding Legal Advice

The prospectus for MarketCounsel's services contained several provisions that proved fatal to DVU's claim of privilege:

- It stated that the firm "do[es] not provide legal or accounting services and [that] no portion of the Services should be considered legal advice."
- It also provided, "[U]nder a MarketCounsel engagement, our staff attorneys do not serve as attorneys for our members. These same individuals may be engaged to serve as attorneys for our members through our separate but affiliated law firm, the Hamburger Law Firm. This representation is done under a separate written agreement and fee."
- It made clear that its staff attorneys were not providing legal advice under the MarketCounsel service agreement and that communications with them were not protected by the attorney-client privilege.

See "Six Recommendations for Hedge Fund Managers Seeking to Protect Themselves From Waiver of Attorney-Client Privilege When Faced With SEC Document Requests" (Jan. 17, 2013).

DVU Did Not Have a Good-Faith Belief That It Was Seeking Legal Advice

For privilege to attach, although it is not necessary to have a formal attorney-client

relationship, the party claiming privilege must have a good faith belief that it is seeking legal advice. DVU could not have had that belief because it had "repeatedly rejected an attorney-client relationship with the Hamburger Law Firm in favor of a MarketCounsel membership (whose terms and conditions expressly disclaim any attorney-client relationship or privilege whatsoever)," the Court reasoned.

MarketCounsel's disclaimers, and the absence of a representation agreement between DVU and the Law Firm, created a "strong presumption" that the communications in question were not privileged. Those disclaimers were "clear, specific, and repeated ad nauseam," the Court said. In addition, on at least two occasions, DVU's in-house attorney had specifically recommended the MarketCounsel program over engaging the Law Firm.

DVU's Relationship With MarketCounsel Did Not Change Until the SEC Issued a Deficiency Letter

An attorney-client relationship could conceivably develop over the course of a relationship that clearly did not start out as one, the Court observed. Under other circumstances, the services provided by MarketCounsel attorneys could reasonably be considered legal services.

Nevertheless, 45 of the communications over which DVU claimed privilege concerned matters that were explicitly contemplated by the MarketCounsel membership agreement, which specifically disclaimed that the firm was providing legal advice or legal services. Those 45 communications all occurred before the SEC issued its post-exam findings in November 2018.

Post-Deficiency Letter Communications Are Privileged

DVU's agreement with MarketCounsel "explicitly viewed the issuance of a deficiency letter as the bright line separating MarketCounsel's compliance services from [the] Law Firm's legal services," according to the Order. Two communications over which DVU asserted privilege occurred after the issuance of the deficiency letter. In them, DVU sought legal advice as to how to respond to the SEC findings. Because the communications concerned services not contemplated by the MarketCounsel agreement, they are "best seen as statements made for the purpose of obtaining legal advice" and entitled to the protection of the privilege, the Court reasoned.

In addition, the SEC deficiency letter created the prospect of litigation. Therefore, those two communications were also entitled to protection under the work-product doctrine.

See "Three Steps in Responding to an SEC Examination Deficiency Letter and Other Practical Guidance for Hedge Fund Managers From SEC Veteran and Sutherland Partner John Walsh" (Feb. 13, 2014).

Privilege Waived As to Tax Opinions

BDO USA, LLP (BDO) was DVU's accounting firm. From time to time, DVU would refer clients who had questions about the tax treatment of QROPS to BDO for consultations. Alderson, acting in his capacity as DVU's CEO,

"made a calculated decision to send the [Tax Opinion] to BDO, apparently in an effort to induce BDO to reach the same conclusions as Carlton Fields had reached, so as to convince prospective clients of the tax benefits of the QROPS," according to the Order.

Attorney-client privilege is generally waived as to communications that a party voluntarily discloses to a third party. The Court concluded that Alderson's disclosure constituted a voluntary waiver of privilege by DVU.

This is "a potentially disastrous result in the context of pending litigation with the SEC," explained David M. Levy, partner at Kleinberg Kaplan. The decision "highlights the need for investment advisers to safeguard against the inadvertent waiver of privileged communications through disclosure to third parties," he added. Sharing privileged information or documents with clients, business partners, marketers, consultants and other third parties, which may seem to make good business sense, can result in waiver of privilege.

Common Interest Doctrine Does Not Apply

Under certain circumstances, disclosure of a privileged communication to a third party engaged in a "common legal enterprise" with the disclosing party does not result in a waiver of privilege. Distinguishing the Second Circuit's decision in *Schaeffler v. United States*, the Court rejected DVU's contention on those grounds in this case, however. Unlike the third party in *Schaeffler*, BDO had "no stake in the tax treatment of QROPS" and would have been paid regardless of the conclusion it reached as to taxability. There was no evidence that DVU and BDO ever worked together to achieve any particular tax benefit. Moreover, by the time DVU provided the Tax Opinion to BDO, "DVU was already convinced that QROPS was non-taxable."

"Sharing communications through a more structured information flow and in a more disciplined manner could minimize the chances of inadvertent waiver," Levy explained. If DVU's outside counsel collaborated in some fashion with the accounting firm to formulate its Tax Opinion pursuant to a *Kovel*-type engagement (discussed below), "the ultimate disclosure of the Tax Opinion to the accountants might have remained protected," he added. The fact that DVU and BDO may have had a common goal to market the investment strategy to prospective and existing clients was insufficient to preserve the privilege.

See "How Hedge Fund Managers May Address the Practical Implications of the NY Court of Appeals Attempt to Clarify the Common Interest Doctrine" (Sep. 29, 2016).

Attorney Work-Product Doctrine Does Not Apply

"DVU obtained the Tax Opinion to assess the viability of QROPS as a business model and to improve DVU's sales pitch to investors, rather than in anticipation of litigation," the Court reasoned. Therefore, the Tax Opinion was not entitled to protection as work product.

"Unlike the traditional attorney-client privilege analysis – where the written or oral communication must be made in connection with seeking or giving legal advice – the attorney work-product doctrine only protects documents when they are prepared in the context of actual or threatened litigation," Levy said. Unfortunately, in this case, "the mere

novelty of the tax structure was not sufficient to bring it within the specter of threatened litigation; therefore, the Court held that the Tax Opinion was not protected under attorney work-product doctrine," he added.

See "How Fund Managers Can Maintain Work Product Protection During Investigations After the *Herrera* Decision" (Feb. 22, 2018).

Best Practices for Preserving Privilege

1) Use *Kovel*-Type Arrangements When Engaging Consultants

The *Alderson* case "provides essential guidance regarding the use of consultants, information management and, most importantly, how to safeguard privileged information by carefully structuring consulting relationships with the assistance of counsel," explained Levy. One way to accomplish this is through what is commonly known as a "*Kovel*" arrangement, under which privilege may be extended to communications with consultants and non-legal experts.

Under *Kovel*, which is not referred to in the Order but remains good law, "communications involving a non-attorney consultant will be protected under the attorney-client privilege if the communication is 'made in confidence for the purpose of obtaining legal advice from the lawyer.' While this proposition is simple to articulate, it can be extremely challenging to effectuate in the real world," Levy explained.

A key factor in the Order was that DVU directly engaged MarketCounsel. Although MarketCounsel was staffed with lawyers, it was engaged strictly to consult on regulatory matters, expressly disclaiming any obligation to provide legal advice, Levy explained. As a result, due to the way this engagement was structured, "the consultant's communications with the adviser were held to be non-privileged," he noted.

"The adverse situation in *Alderson* could possibly have been avoided had the compliance consultants – whose advice was not privileged because they were expressly not engaged to provide legal advice – been engaged either by general counsel or by DVU's outside counsel through a *Kovel*-styled engagement," Levy remarked. "By structuring the relationship to channel the consultant's expert communications to the lawyers in order to assist in the rendition of legal services to DVU, the otherwise privileged information flow between consultant-lawyer-client might still remain privileged," he continued.

See our three-part series on how fund managers can structure *Kovel*-compliant arrangements: "Key Considerations for Fund Managers When Utilizing, Invoking and Waiving the *Kovel* Privilege for Consultants" (Oct. 20, 2016); "Practical Tips for Preparing an Engagement Letter for, and Implementing, a Compliant *Kovel* Arrangement" (Oct. 27, 2016); and "Specific Circumstances Where Fund Managers May – and May Not – Be Able to Use *Kovel* Arrangements" (Nov. 3, 2016).

2) Separate Business and Legal Functions

Attorney-client privilege attaches only when the attorney is acting in his or her capacity as a lawyer and the communication is for the purpose of seeking or providing legal advice, Levy explained. General counsels and associate general counsels who also have non-legal

functions or titles "may not always be communicating with the protection of privilege where, for example, they are counseling on regulatory, business or compliance matters," he added.

If a general counsel is engaged in a pure compliance matter or is offering general business advice pertaining to matters that are not purely "legal," Levy explained that "there is a risk that those communications may be deemed non-privileged. The risks under these circumstances can be minimized simply by using single titles for legal, compliance and risk officers – separating legal from business and other functions."

See "Simon Lorne, Chief Legal Officer of Millennium Management LLC, Discusses the Evolving Roles, Challenges and Risks Faced by Hedge Fund Manager General Counsels and Chief Compliance Officers" (Sep. 26, 2013); and "Benefits, Challenges and Recommendations for Persons Simultaneously Serving As General Counsel and Chief Compliance Officer of a Hedge Fund Manager" (May 10, 2012).

3) Adopt Appropriate Protocols for Privileged Communications

Levy attributed certain of the problematic disclosures by DVU to the business-driven actions of its high-level managers. "The entire situation might have been avoided had there been policies and protocols in place governing the disclosure or escalation of legal advice or attorney work product," he said.

Additionally, employees should be trained on privileged communications and on how to protect privilege, Levy advised.

4) Label Documents Appropriately

Documents and emails provided to or received from third-party consultants and experts should be clearly marked as "Confidential," "Attorney-Client Privileged" or "Attorney Work-Product," when appropriate, Levy recommended. "Properly labeling documents intended to be privileged helps not only to establish the privileged nature of the communication, but also to minimize the chances for unintended or incidental disclosure to third parties which might destroy the privilege," he noted.