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Dangerous Liaisons

By Richard A. Zitrin and William M. Balin

Few areas of legal practice are as ethically bewildering as representing corporations during an era of mergers, acquisitions, and takeovers. Frequently events beyond the control—or the knowledge—of lawyers subject both in-house and outside counsel to divided loyalties and possible conflicts of interest. Even the simple question "Who is my client?" may be difficult to answer.

To advise an employer involved in mergers and acquisitions, house counsel must have some knowledge of how courts determine the existence of a conflict of interest in the corporate setting. It's important to know how conflicts affect both in-house representation and that of outside counsel. A conflict on the part of outside counsel can result in the firm's disqualification, which means wasted time and expense for your client.

Consider the following hypothetical example. Enormo Inc. decides to acquire Middling Manufacturing, a smaller competitor. Enormo asks its general counsel to provide legal advice and assistance to both companies. She is directed by the boards of directors of both companies to meet with outside counsel, who is currently working to resolve issues of competing patent applications so that the merger can proceed smoothly. If the Federal Trade Commission (FTC) steps in to investigate a complaint that the merger violates antitrust laws, what are the obligations of house counsel, and who is her client?

In *Federal Trade Comm'n v Exxon Corp.* (DC Cir 1980) 636 F2d 1336, a similar dilemma arose when Exxon sought to acquire Reliance Electric Co., primarily to take advantage of technology for electric motor controllers developed by Reliance's Drives Group division. In response to an antitrust complaint, the district court ordered Exxon to keep the division separate and independent in case it should later order Exxon to divest it. The court directed that neither Exxon nor the Drives Group could exchange "confidential competitively sensitive information" during the course of the FTC proceeding and prohibited both Exxon's in-house and retained counsel from representing or advising the Drives Group. The court also barred in-house counsel from having access to the Drives Group's confidential information that had been made available to the FTC. Exxon appealed.

The court of appeals upheld both orders based on the conflicts of interest between Exxon and the Drives Group. Because Exxon was developing its own competing technology, the appeals court was concerned that Exxon would allow the Drives Group to wither. In addition, if the FTC denied the acquisition on antitrust grounds, Exxon and the Drives Group would remain competitors. Since in-house counsel had access to information about Exxon's own competing technology, the appeals court held that house counsel could not have access to similar information from the Drives Group.

Applying the logic outlined in *FTC v Exxon*, it is clear that Enormo and Middling remain potential competitors. In order for Middling to preserve its secrets, the company should hire separate counsel to represent it in patent negotiations with Enormo and in the administrative action before the FTC.

Suppose that Enormo succeeds in acquiring Middling and then, several years later, decides to sell it. Enormo directs its general counsel to defend it in a lawsuit brought by Middling relating to the sale. Again, it is difficult to see how she could accept this representation. She undoubtedly will have gained some confidential information about Middling during the years it was part of Enormo, either through her own work or by consulting with other attorneys who represent Middling. The issue was addressed in *G.F. Industries, Inc. v American Brands, Inc.* (NJ Super Ct, App Div 1990) 583 A2d 765. In this case an outside firm had represented both a subsidiary, Sunshine Biscuits, Inc., and its parent, American Brands, Inc., in numerous matters. American Brands sold Sunshine to G.F. Industries, Inc., which then sued American for breach of warranty relating to Sunshine's equipment. The court held that the firm could not defend the parent (American), because it had acquired confidential information about its

> Corporate lawyers must be aware of conflicts of interest inherent in mergers and acquisitions.

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former subsidiary (Sunshine) relevant to the pending litigation.

When there is no ongoing sale or acquisition, the central issue for conflict of interest purposes is often whether or not a parent company and its subsidiary are two separate entities. There is little uniformity in the case law and ethics opinions on this point. Not only is it unclear whether, and when, representation of one company should be considered representation of the other, but ethics committees cannot even agree on how to approach the problem.

For instance, two important opinions conclude, at least in theory, that a corporation and its subsidiary are separate entities for the purposes of determining conflicts of interest. The State Bar of California's Committee on Professional Responsibility and Conduct determined that a corporation and its subsidiary should not be treated as the same entity for conflict purposes unless one is the alter ego of the other or has a sufficient "unity of interests." A parent company's sole ownership of its subsidiary's stock does not mean that the parent's attorneys also represent the subsidiary. See *Cal State Bar Formal Op* 1989-113. Similarly, the American Bar Association's ethics committee concluded that a lawyer who represents a corporate client may, in limited circumstances, represent a client with interests adverse to the corporate client's affiliate. *ABA Formal Op* 95-390.

The case law, however, either disagrees with these opinions or disagrees on how to interpret them. California law is a perfect example. In *Teradyne Inc. v Hewlett-Packard Co.* (ND Cal 1991) 20 USPQ2d 1143, Teradyne sued Hewlett-Packard (H-P) for patent infringement. One law firm representing Teradyne also represented H-P's wholly owned subsidiary Apollo Computer in trademark matters. Based on the "identity of interest" between H-P and Apollo, the court held that the firm had a conflict of interest in representing both Teradyne against H-P, and Apollo, and disqualified the firm from representing Teradyne.

Two appellate courts reached different conclusions in two related cases arising from lawsuits brought in New York and California by Brooklyn Navy Yard Cogeneration Partners, L.P. against Parsons Corp. See *Brooklyn Navy Yard Cogeneration Partners LP v. PMNC* (NY Sup Ct 1997) 663 NYS2d 499, affd (1998) 679 NYS2d 312; *Brooklyn Navy Yard Cogeneration Partners LP v Superior Court (Parsons Corp.)* (1997) 60 CA4th 248. In these cases Parsons sought to disqualify the lawyers representing Brooklyn Navy Yard (BNY), because at the time the company sued Parsons, BNY's lawyers were already representing a Parsons subsidiary in ongoing, unrelated legal matters in Russia. The New York court denied the motion to disqualify; the California court remanded, directing the trial court to determine if the parent was the alter ego of the subsidiary.

Despite similar results, the two *Brooklyn Navy Yard* courts reasoned quite differently. The New York court concluded that the law firm's Russian outpost was isolated from the lawyers representing BNY in the United States and that the lawyer in Russia had not

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learned anything that could be considered relevant confidential information useful to the New York partners for BNY's case. The California court of appeal interpreted the State Bar's ethics opinion, holding that a parent corporation should not be deemed the client of an outside firm simply because the firm also represented a subsidiary of the parent corporation, even if parent and subsidiary had a unity of interests. Indeed, the California case set the conflicts bar considerably higher: The court of appeal held that *only* when the subsidiary and parent are alter egos of each other will the firm's representation of one constitute representation of the other and require the firm's disqualification.

But *Brooklyn Navy Yard* was hardly the last word in California. Just 15 months later, in *Morrison Knudsen Corp. v Hancock, Rothert & Bunshoft* (1999) 69 CA4th 223, another district of the court of appeal adopted the "unity of interests" test that *Brooklyn Navy Yard* had rejected and found that a conflict of interest *did* exist.

In *Morrison,* the Hancock law firm had represented Morrison on several matters some years earlier. Hancock was then hired by Morrison's insurer as the insurer's counsel to oversee litigation involving Morrison and its subsidiary, Centennial Engineering Inc. When a county water district sued Centennial for problems with a construction project, it hired Hancock. Morrison, though not a party to that litigation, successfully moved to disqualify Hancock from representing the district, even though Hancock did not then represent Morrison and had never represented Centennial. The court held that there was a sufficient "unity of interests" between the subsidiary Centennial and its parent to treat them as a single entity for the purpose of determining whether a conflict of interest required Hancock's disqualification.

What do these cases mean for in-house counsel? Of course, they provide some comfort for the distress a company feels when its law firm, without its consent, represents one corporate affiliate and then sues another affiliate. More important, the court decisions reveal a set of specific factors that affect the outcome of such cases regarding whether (1) the legal work for one corporate entity is intended to benefit all affiliates, (2) the parent company's board or in-house counsel exercises control over the legal work done for the subsidiary, and (3) in-house counsel confers with the subsidiary's counsel or is privy to the subsidiary's confidential information.

Given the broad parameters for disqualification, these cases also should alert house counsel to closely question outside firms before retaining them. For instance, the *Morrison* court found a second basis for disqualifying Hancock: The law firm could not represent the water district because by representing Morrison's insurer, it received confidential information about Morrison's subsidiary, Centennial, *through the insurer.* In another case, *GATX/Airlog Co. v Evergreen Int'l Airlines, Inc.* (ND Cal 1998) 8 F Supp 2d 1182, a bank successfully intervened and disqualified a law firm that represented it on matters unrelated

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to the case. Though not a party to the litigation, the bank was able to show that it had an interest in the outcome contrary to that being advanced by its outside counsel for the firm's client, GATX.

Still another issue concerns mergers. What happens when a law firm winds up representing one corporate affiliate while opposing another when the conflict arises not because of the firm's own behavior but as a result of a corporate merger? In *Pennwalt Corp. v Plough, Inc.* (D Del 1980) 85 FRD 264, a law firm defended Scholl, Inc. in an antitrust lawsuit while it helped Pennwalt Corp. sue Plough, Inc., a subsidiary of Schering-Plough Corp., for unfair advertising. When Scholl was acquired by Schering-Plough, the firm found itself both representing and suing sister affiliates of the same company. The court allowed the law firm to remain in the *Pennwalt* litigation against Plough because nothing it had learned in representing Scholl was relevant to the case. However, the firm had withdrawn as Scholl's counsel when it learned of the merger.

In still another case, *Gould, Inc. v Mitsui Mining & Smelting Co.* (ND Ohio 1990) 738 F Supp 1121, a law firm found itself representing both the plaintiff and a subsidiary of the defendant in the same case. Since it was the client's merger that caused the conflict, the court allowed the firm to choose which client to represent.

Although current ethics rules don't specifically address this issue, in February the ABA's Ethics 2000 commission sent out for public comment its revised conflict of interest rule, Model Rule 1.7. Among the proposed changes is a commentary paragraph that follows the *Gould* case and suggests that "[o]rdinarily, the lawyer should withdraw from the representation of the client who will be least harmed."

Even when the conflict of interest is brought about by the client's merger or acquisition, however, a law firm's ability to continue in the case is by no means automatic. In *Baxter Diagnostics Inc. v AVL Scientific Corp.* (CD Cal 1992) 798 F Supp 612, a firm seeking to represent AVL in a patent infringement suit brought by Baxter had previously given advice on the same patent to a company that since had merged with Baxter's parent. Because there was a "real possibility" that the lawyers would be called as witnesses and the prior representation of the newly acquired subsidiary was substantially related to the defense of Baxter's claim, the court disqualified the firm from defending AVL.

Returning to the hypothetical, Enormo's general counsel can advise her employer on the effect of controlling the legal activities of its subsidiary, as well as consult with the affiliate's outside counsel. She can point to the advantages and disadvantages of Enormo and its subsidiaries having similar boards of directors. She can advise on the likely effects of mergers, acquisitions, and sales of corporate affiliates on future representation. In addition, she serves her employer best by advising it of potential and actual conflicts of interest at the earliest possible time. And she should expect outside counsel to Enormo and its affiliates to do the same. ❑

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