When Great Minds Don't Think Alike: Avoiding Conflicts of Interest When Corporate Constituents Disagree

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ACC Association of Corporate Counsel

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Avoiding Conflicts of Interest

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Overview

- Understanding Conflicts in Rules of Professional Conduct
- Identifying and Assessing Conflicts of Interest
- Maintaining Clarity in Attorney-Client Relationship to Avoid Conflict(s)
- Inter-Client Conflict Scenarios
- Intra-Client Conflict Scenarios
- Attorney-Client Conflict Scenarios

Rules of Professional Conduct – Rule 1.7(a)

Rule 1.7(a) A lawyer shall not, without informed written consent from each client and compliance with paragraph (d), represent a client if the representation is **directly adverse to another client in the same or a separate matter.**

- Comment [2] tells us that "same or separate matter" applies to circumstances such as the formation of a partnership or corporation.
- Most frequently arises in business transactions when a lawyer represents two or more partners in a partnership whose interests turn from amicable to conflicted.

Rules of Professional Conduct – Rule 1.7(b)

Rule 1.7 (b) A lawyer shall not, without informed written consent from each affected client and compliance with paragraph (d), represent a client if there is a significant risk the lawyer's representation of the client will be materially limited by the lawyer's responsibilities to or relationships with another client, **a former client or a third person, or by the lawyer's own interests.**

Rules of Professional Conduct – Rule 1.7(d)

- Representation is permitted under this rule only if:
  1) The lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
  2) the representation is not prohibited by law; and
  3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.

- Need to assess whether you have an actual or potential conflict before undertaking any representation beyond primary corporate client.

Identifying Actual or Potential Conflict

Two-part question:

1) What is the likelihood that a difference in interests between the two subjects of representation exists or will arise?
2) If it does, will it foreclose courses of action that the lawyer should reasonably pursue or recommend on behalf of each client?

Also consider:

1) Is client confidentiality compromised (successive representation)?
2) Is client loyalty compromised (concurrent representation)?

Who is your client?

Rule 1.13: Organization as Client

a) A lawyer employed or retained by an organization shall conform his or her representation to the concept that the client is the organization itself, acting through its duly authorized directors, officers, employees, members, shareholders, or other constituents overseeing the particular engagement.

"The attorney owes undivided allegiance only to the corporate entity which he or she represents rather than any affiliated persons or entities."

- *Meehan v. Hopps* (1956) 144 Cal.App.2d 284, 290 [301 P.2d 101]

Can I represent both organization and constituents?

Technically, yes. Real answer: it depends.

- Rule 1.13(g): A lawyer representing an organization may also represent any of its constituents, subject to all of the conflict and disclosure rules (e.g., Rules 1.7, 1.8.2, 1.8.6, and 1.8.7).
- If the organization's consent to the dual representation is required, the consent shall be given by an appropriate official, constituent, or body of the organization other than the individual who is to be represented, or by the shareholders.
  - If you are representing a corporation and its president, the president cannot sign the conflict waiver on behalf of the corporation.

Dual Representation: Partnership & Partners

Representation of a partnership does not *per se* constitute representation of the individual partners.

- *Johnson v. Superior Court* (1995) 38 CA4th 463, 45 CR2d 312 (no *per se* fiduciary duty to partners, but duty to look out for the interests of all the partners as to their "entitlement to benefits of the partnership".) If attorney cannot accomplish because of conflicts of interest among partners, attorney has duty to terminate representation or obtain conflict waivers.

Fiduciary duties to the partnership *can*, but do not always, limit ability to represent partners personally.

- *Wortham & Van Liew v. Superior Court* (1987) 188 CA3d 927, 932, 233 CR 725 (attorney for partnership cannot withhold from one partner important information received from another partner related to partnership transactions.)

Dual Representation: Corporation and Shareholders

Lawyer's fiduciary duty is to corporation itself, not to shareholders.

- A lawyer is not prohibited from taking actions on behalf of the corporation that negatively impact the interests of a shareholder. *Skarbrevik v. Cohen, England & Whitfield* (1991) 231 CA3d 692
- Once conflict has arisen between a corporation and officers, directors or shareholders, corporate counsel **may not** simultaneously represent the corporation and the adverse constituent.
- ***Caution***:
  - Closely-held corporations have more opportunity for inadvertent confidentiality and fiduciary issues to arise.
  - If lawyer is a board member or a shareholder, lawyer has fiduciary duties to shareholders.

Dual Representation: LLC and Members

No fiduciary duty to individual members so long as lawyer's conduct does not give rise to implication or understanding that lawyer represents individual members.

- *Sprengel v. Zbylut* (2019) 40 CA5th 1028, 253 CR3d 561 (attorney for LLC had no duty to one owner in dispute between co-owners because attorney did not conduct himself in such a way as to indicate he was representing interests of co-owner in addition to LLC.)

Why Identity of Client Matters

- Determines whether attorney can or must disclose confidential client information with that person.
- Determines whether communications are privileged.
- Determines whether there is a duty to the person.

Best Practice: Maintain Clarity in Attorney-Client Relationship

- Rule 1.13(f): In dealing with an organization's constituents, a lawyer representing the organization shall explain the identity of the lawyer's client whenever the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituent(s) with whom the lawyer is dealing.
- Communicate frequently the scope and limitations of your client relationship.
- Implement documentation policies and communication rules and procedures for constituents to communicate with GC office.

How does conflict arise in a corporate context?

- Inter-client: Dual representation of company and employee/management, parent/subsidiary, joint partners
- Intra-client: Disagreement among constituents, partnership dispute, corporate divorce
- Attorney-client: Attorney as director, whistleblower, litigant

Inter-Client Conflict Scenarios

PARENT/SUBSIDIARY OR PARTNERS HAVE CONFLICTING INTERESTS IN PENDING DEAL OR LITIGATION & ATTY REPRESENTS BOTH.

CORPORATE COUNSEL REPRESENTS EMPLOYEE IN DEPOSITION.

CORPORATE COUNSEL REPRESENTS DIRECTOR IN INVESTIGATION OR IN DECISION AGAINST OTHER DIRECTORS.

Scenario – Parent and Subsidiary Adverse

Attorney Smith represents Able Company, a large, publicly-traded company. Able Company has a wholly-owned subsidiary, Brand Company, which Attorney Smith does not represent. Potential Client John asks Attorney Smith to bring a lawsuit against Brand Company for failure to pay John's invoices for products Brand Company ordered from him. Company A will not be a party to the lawsuit.

Does Attorney Smith's lawsuit against Brand Company constitute a conflict?

Answer: It Depends

- **Prevailing view**: Corporate affiliation alone does not create a conflict but must consider loyalty and confidentiality issues.
- **State Bar Formal Opinion No. 1989-113** (applying former Cal. R.P.C. Rule 3-310(B)):
  - Attorney "does not represent conflicting interests when he or she acts adversely to a wholly-owned subsidiary of an existing corporate client. The attorney's duty of loyalty does not encompass the obligation to refrain from actions which may have only indirect adverse effects on existing clients in matters unrelated to those which the attorney is handling…"
- **Key exceptions**:
  - Alter ego (sufficient unity of interests to be treated as same entity for conflict purposes).
  - Receipt of confidential information from subsidiary under circumstances where subsidiary could reasonably expect attorney to keep such information confidential.

Representation of Subsidiary Against Parent

- Representing wholly-owned subsidiary creates no attorney-client relationship with parent by virtue of representation of subsidiary alone.
- Attorney for subsidiary has no conflict suing parent corporation in an unrelated matter.
  - *Brooklyn Navy Yard Cogeneration Partners, L.P. v. Superior Court* (1997) 60 CA4th 248, 254.

Scenario – Corporate Counsel Represents Employee

Big Company conducts investigation into accident at its factory. Employee Johnson speaks to the investigators and tells them Big Company was not at fault. Johnson is identified as a witness in the ensuing litigation, and Big Company offers that its own in-house counsel will represent Johnson at his deposition. During deposition preparation, Johnson tells counsel he lied to the investigator, and he believes Big Company was at fault after all. Counsel tells Johnson just to go ahead and sit for his deposition and make sure he testifies truthfully.

Does Big Company's counsel have a conflict of interest?

Answer: Yes – Attorney Has Non-Waivable Conflict

Why is conflict non-waivable?

- If employee proceeds to testify truthfully against company at deposition, counsel will have to cross-examine his own client to maintain loyalty to company.
- If employee testifies company is not at fault, counsel knows he is offering testimony that is false.

Yanez v. Plummer (2013) 164 Cal. Rptr. 3d 309

- Employee testified truthfully, was fired by company, successfully brought malpractice claim against attorney.

Scenario – Representation of Management

When an attorney represents a corporation dominated by one officer or a single-member/single-manager LLC ***and*** the officer or managing member's personal interests to a considerable extent are identical to the interests of the company, does an attorney-client relationship automatically exist between the attorney and the officer or managing member?

Representation of Management Cont'd.

No! The attorney for a corporation represents it, its stockholders, and its officers in their representative capacity, but **not in their personal capacity**, unless an attorney-client relationship is specifically formed.

Corporate attorney is ***not*** disqualified from representing corporation in an action brought by corp. against one of its officers, and attorney ***may*** use information received from officers and directors in course of business relationship.

Caution – Closely-Held Corporations And Partnerships

Counsel must be mindful that small, closely-held corporations and partnerships in which counsel has worked intimately with the sole owner or the two partners create difficult ethical issues for counsel.

- E.g.: Counsel for small partnership jointly owned by husband and wife cannot represent one spouse in divorce against the other spouse because both spouses are "current clients" of counsel due to nature of partnership.
  - *Hecht v. Superior Court* (1987) 237 Cal. Rptr. 528.

Implied Attorney-Client Relationship

- In-house counsel can create ***implied*** attorney-client relationship giving rise to malpractice liability for undisclosed conflicts.
- *Responsible Citizens v. Superior Court* (1993) 16 Cal.App.4th 1717
  - Looks at totality of circumstances and list of factors including size of partnership, nature and scope of engagement, and attorney's access to partner information to determine whether conduct gave rise to implied attorney-client relationship.
- *Sprengel v. Zbylut* (2019) 40 Cal.App.5th 1028
  - Asks whether the parties conducted themselves in a way that would reasonably cause a partner to believe the attorney would protect the partner's individual interests.

Best Practices to Avoid Inter-Client Conflicts

- Obtain conflict waivers and informed written consent if undertaking additional representation of constituents.
- Refrain from taking part in factional differences among shareholders as to control of the corporation in order to advise the corporation without conflict.
- Recommend outside counsel for non-represented companies or constituents to facilitate communication.
- Discuss with client spokesperson confidentiality issues, privilege issues, potential for future conflicts.
- Clearly communicate identity of client when obtaining confidential information to avoid implied attorney-client relationship.
  - Give and document giving of *Upjohn* warning.

Intra-Client Conflict Scenarios

COUNSEL APPROACHED BY MULTIPLE INDIVIDUAL INTERESTS DURING CORPORATE DISSOLUTION

CONSTITUENTS DIRECT ATTORNEY TO ACT IN WAYS HARMFUL TO ORG.

CONSTITUENTS DISAGREE ON CORPORATE GOVERNANCE

Role of Corporate Counsel in Corporate Divorce

- Exercise caution in advising individual constituents aside from organization itself.
- Counsel can represent remaining shareholders/partners against departing partner if:
  - Interests of remaining partners align with interests of organization, and
  - Counsel complies with requirements of Rule 1.7.
- Always look ahead to potential for representation of corporation *against* director(s) (such as receivership in case of fraud by director, or defense of corporation in wrongful termination suit).

When Constituents Disagree

What are a lawyer's ethical duties when the lawyer receives conflicting instructions and it is unclear which person's instruction the lawyer must follow?

- FIRST: Conform to applicable statutes and organizational documents.
- SECOND: Try to work with the partners to resolve the dispute, while explaining the likely consequences if the dispute is not resolved.
- THIRD: If not resolved, lawyer may withdraw if unreasonably difficult for lawyer to continue representing partnership effectively.
- REMEMBER: Do not act on instruction of one partner if dispute remains unresolved.

When Constituents Act Unlawfully

Rule 1.13 requires that attorneys report to the "highest internal authority" conduct which the lawyer knows or should know is a violation of law if certain conditions are met.

Examples:

- Volkswagen emissions scandal
- Unlawful employment practices

Rule 1.13: Two-Part Test for Reporting Up

(1) Does the lawyer have actual knowledge that a constituent is, has, or plans to act (or refuses to act)?

(2) Would a reasonable lawyer conclude that the constituent's course of action is a violation of law or a legal duty and likely to result in substantial injury to the organization?

“Highest Internal Authority”

Who is “highest internal authority”?

- Corporation: Board of Directors
- Limited Partnership: Generally, the general partner(s)
- LLC: Manager or the managing member, if one has been appointed under the terms of the articles of organization

[Corp Code § 17703.01(b)(1)].

When “Reporting Up” Fails

Rule 1.13 integrates a provision set forth in former Rule 3-600(C) allowing attorneys to exercise their right, and where appropriate, duty, to resign or withdraw if a corporation’s highest authority insists upon action or fails to act in a manner that is a violation of a legal obligation to the organization or a violation of a law reasonably imputable to the organization and is likely to result in substantial injury to the organization.

When Constituents Act Against Interest of Organization

Does corporate counsel have to accept actions/decisions of directors even if contrary to counsel's advice or appear to be harmful to the interests of the organization?

- Generally yes, if actions not unlawful.
- "A lawyer ordinarily must accept decisions an organization's constituents make on behalf of the organization, even if the lawyer questions their utility or prudence. It is not within the lawyer's province to make decisions on behalf of the organization concerning policy and operations, including ones entailing serious risk." [Comment [2] to Rule 1.13.]

Duty to Inform

- Lawyer **always** has a duty to inform the client of significant developments related to the representation.
  [Rule 1.4; Business and Professions Code section 6068(m).]
- Even if there is no mandatory reporting obligation under Rule 1.13, the lawyer ***may*** refer to higher authority any matter the lawyer reasonably believes is sufficiently important to refer **in the best interest of the organization.**

When Highest Internal Authority Is Wrongdoer

- Withdraw if necessary – if sole person in control of the corporation is operating a fraudulent scheme, attorney has right (and sometimes duty) to resign or withdraw from representation [see Cal Rules Prof Conduct, Rules 1.13(d), 1.16].
- *Meehan v. Hopps* (1956) 144 CA2d 284, 301 P2d 10, attorney for corporation was permitted to act as counsel for receiver over the corporation, in an action against former director and chairman of the board, based on allegations of self-dealing and breach of duty to the corporation.

Attorney-Client Conflict Scenarios

ATTORNEY AS CORPORATE DIRECTOR

ATTORNEY AS WHISTLEBLOWER

ATTORNEY AS LITIGANT

Attorney as Director

Opportunity for conflict to arise

- Attorney may be forced to consider personal interests alongside corporation's, which creates conflict.
- Attorney may have to take position contrary to others on board of directors, to whom attorney as corporate counsel reports.
- Communications not privileged when attorney is serving in business role rather than legal role.
- Corporate counsel becomes both attorney and client.

Attorney as Whistleblower

- In-house attorneys may use privileged and confidential materials under limited circumstances in support of a whistleblower retaliation claim.
- Whistleblower protections under federal laws such as the Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) prevail over conflicting state ethical rules governing the scope of attorney-client privilege and confidentiality.

Attorney as Whistleblower cont'd.

- *Wadler v. Bio-Rad*, 212 F. Supp. 3d 829 (N.D. Cal. 2016)
  - GC asked audit committee to investigate senior management involved in a possible bribery scandal in China – a violation of the Foreign Corrupt Practices Act.
  - After a four-month investigation, no direct evidence of misconduct was found.
  - Three days later, GC was terminated.
  - GC sued for whistleblower retaliation.
  - Company sought to exclude all evidence based on information GC learned in the course of his employment as confidential and privileged.
  - Court held information admissible.

Attorney as Litigant: Wrongful Termination

- Former in-house counsel may be able to divulge client confidences and attorney-client privileged communications to support his or her wrongful termination suit.
- See *Fox Searchlight Pictures, Inc. v. Paladino* (2001) 89 Cal.App.4th 294, 308 (In a wrongful termination action, a "former in-house counsel may disclose to her attorney all facts relevant to the termination, including employer confidences and privileged communications.")

Attorney as Litigant: Legal Malpractice Defendant

Attorney-client privilege and duty of confidentiality both limited when client sues attorney for malpractice.

- **Evidence Code section 958**: "There is no privilege under this article as to a communication relevant to an issue of breach, by the lawyer or by the client, of a duty arising out of the lawyer-client relationship."
- **Bus. & Prof. Code section 6068(e)** duty to maintain client confidentiality is "modified by the exceptions to the attorney-client privilege contained in the Evidence Code." *Fox Searchlight Pictures, Inc. v. Paladino* (2001) 89 Cal.App.4th 294, 313.
- Unfair for a party to sue upon advice provided by an attorney and then seek to prevent the attorney from presenting evidence pertaining to why the advice was given. *Solin v. O'Melveny & Myers* (2001) 89 Cal.App.4th 451.
- Filing a **malpractice** claim generally results in a waiver of the privilege to the extent necessary to defend the claim. *McDermott, Will & Emery v. Superior Court* (2000) 83 Cal.App.4th 378.

Questions?

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