ETHICALLY SPEAKING

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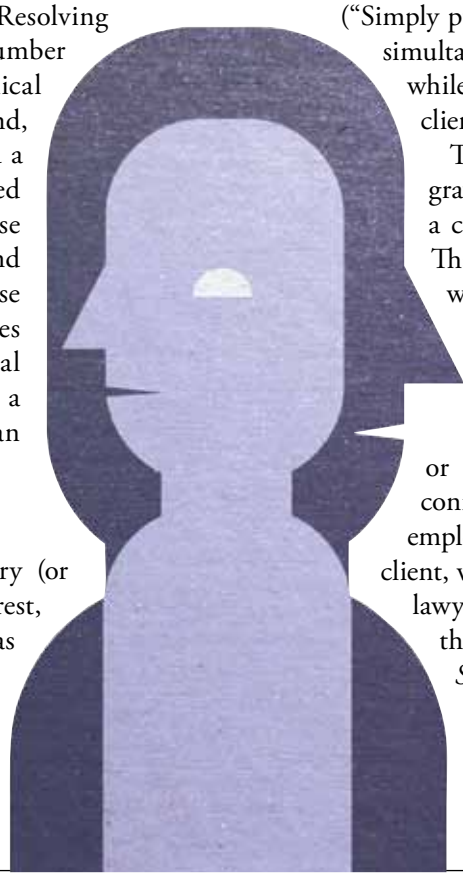
Who's Your Daddy?

Analyzing Parent-Sub Conflicts of Interest

For a plaintiff's malpractice lawyer, conflicts of interest are the greatest thing since the invention of, well, punitive damages. Even a routine negligence claim—for example, a blown statute of limitations—can become an alleged sinister plot if some sort of conflict of interest can be alleged. Suppose the defendant is a California lawyer who filed a complaint after the statutory deadline. He has a partner in his firm's Boston office who represents the parent company of the company the defendant was hired to sue. Can the plaintiff's lawyer argue that the defendant had a conflict of interest and thereby suggest to the jury that the defendant intentionally missed the deadline to help his Boston partner's parent company client? Do we need a playbook to even begin to figure this out?

In short, the question raised by this hypothetical is whether a lawyer can be adverse to a subsidiary when he or his law firm represents that subsidiary's parent. Resolving this issue correctly is important for a number of reasons. First, it is every lawyer's ethical duty to avoid conflicts of interest. Second, a lawyer who fails to recognize and avoid a conflict of interest risks being disqualified from a case—a result that could cause substantial prejudice to his client. And third, as alluded to above, an otherwise straightforward legal malpractice case takes on heightened significance—and potential liability—when the plaintiff can lob in a breach of fiduciary duty claim based on an alleged conflict of interest.



The Basics

To analyze a potential parent-subsidiary (or other affiliated entities) conflict of interest, we start with the basic ethics rules as applied to the representation of any client. California Rule of Professional Conduct 3-310 addresses conflicts of interest both in the context of concurrent and successive representations. Rule 3-310(C)(3) addresses concurrent conflicts and provides that a lawyer

> shall not, without the informed written consent of each client: . . . (3) [r]epresent a client in a matter and at the same time in a separate matter accept as a client a person or entity whose interest in the first matter is adverse to the client in the first matter.

There need be no connection whatsoever between the two matters, nor need there be any realistic fear that the client's confidential information could be used against that client in the other matter. Rather, the lawyer is precluded from being adverse in any way to a current client (absent informed written consent) because of his duty of loyalty to that client. *See Flatt v. Superior Court*, 9 Cal. 4th 275, 284 (1994) (requiring *per se* disqualification where law firm simultaneously opposes and represents a client, even where two matters are not substantially related); *see also Certain Underwriters at Lloyd's, London v. Argonaut Ins. Co.*, 264 F. Supp. 2d 914, 919 (N.D. Cal. 2003) ("Simply put, an attorney (and his or her firm) cannot simultaneously represent a client in one matter while representing another party suing that same client in another matter").

This black-and-white rule becomes somewhat gray when the client in the other matter is not a current client, but rather is a former client. That scenario is addressed in Rule 3-310(E), which states, "A member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment." Unlike a lawyer's duty to a current client, which is governed by the duty of loyalty, the lawyer's duty to his former client is governed by the duty of confidentiality. *See City and Cnty. of San Francisco v. Cobra Solutions, Inc.*, 38 Cal. 4th 839, 846 (2006) (noting duty of loyalty applies to simultaneous representations, while duty of confidentiality applies to successive representations). Thus, Rule 3-310(E) precludes representation of a

former client where the lawyer "has obtained confidential information material to the employment." By way of example, if a lawyer represents a biotech company in connection with prosecution of one of its patents, he likely will not later be able to take on a representation adverse to that same biotech company in a patent infringement lawsuit over another patent based on related technology, even if the lawyer's representation of the biotech company terminated several years earlier. The fear, of course, is that the lawyer may have confidential information about the biotech company's technology which he could use against the company in the subsequent lawsuit. By contrast, the lawyer likely could represent an employee in a racial discrimination-based lawsuit against the former client biotech company. In that lawsuit, it is unlikely the lawyer would have any material confidential information of the biotech company from his prior representation.

Thus, a lawyer must conduct far more analysis when deciding whether he can be adverse to a former client than when deciding whether he can be adverse to a current client. In the latter case, the lawyer never can be adverse to his current client absent informed written consent. In the former case, it will depend on the circumstances surrounding the two representations and, in particular, whether the lawyer obtained confidential information in the first lawsuit that is likely to be material to the second lawsuit. Many courts both in and out of California refer to this as the "substantial relationship" test—that is, if the former representation and the contemplated new representation are substantially related, then the lawyer may not take on the new representation. *See H.F. Ahmanson & Co. v. Salomon Bros., Inc.*, 229 Cal. App. 3d 1445, 1454 (1991) ("[T]he attorney's possession of confidential information will be presumed only when a substantial relationship has been shown to exist between the former representation and the current representation" (internal quotation omitted)); *All Am. Semiconductor, Inc. v. Hynix Semiconductor, Inc.*, Nos. C 07-1200, C07-1207, C 07-1212, C 06-2915, 2008 U.S. Dist. LEXIS 106619, at *18 (N.D. Cal. Dec. 18, 2008) ("In determining whether a 'substantial relationship' exists a court should consider the similarities between the two factual situations, similarities in legal questions posed, and the nature and extent of the attorney's involvement with the case and whether he was in a position to learn of the client's policy or strategy").

Application to Affiliated Entities

This analysis can become even more complicated when there are multiple related corporate entities involved, as in the hypothetical situation described above. While it may be clear that a lawyer may not take on a representation that is adverse to another client of his law firm, it can be as clear as mud whether a lawyer can take on a representation that is adverse to a client's parent, subsidiary, or sister entity, although not to the client itself.

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Prior to 1997, there was little or no guidance to lawyers on this issue. In 1997, and then again in 1999, two courts of appeal addressed the issue in cases that remain good law today. The 1999 opinion, *Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP*, 69 Cal. App. 4th 223 (1999), is the more widely followed of the two.

To start from the beginning, however, in 1997, the Fourth Appellate District, Division Three, issued *Brooklyn Navy Yard Cogeneration Partners, L.P. v. Superior Court*, 60 Cal. App. 4th 248 (1997) (P.J. Sills). In that case, the court reversed a trial court's order disqualifying a law firm from a representation adverse to its current client's subsidiary. Before deciding whether Rule 3-310(C)(3), *Flatt*, and the duty of loyalty applied at all, the court first had to determine whether, for purposes of analyzing the potential conflict of interest, the parent and the subsidiary should be considered a single entity. Of course, the general rule is that organizations are to be treated as separate entities under the Rules of Professional Conduct, and that a lawyer who represents a corporation represents only the corporation and not any constituents of the corporation, such as shareholders, officers, or directors. Rule 3-600 ("[T]he client is the organization itself, acting through its highest officer, employee, body, or constituent overseeing the particular engagement"); *see also Responsible Citizens v. Superior Court*, 16 Cal. App. 4th 1717, 1726-27 (1993) ("The attorney for a corporation represents it, its stockholders and its officers in their representative capacity. He in nowise represents the officers personally"). Thus, as a general matter, a lawyer who represents a subsidiary will not be deemed to be representing that subsidiary's parent or sister entities, and vice versa. But, like any good rule, this one has an exception, which is what *Brooklyn Navy Yard* addressed.

Brooklyn Navy Yard held that a lawyer may be precluded from representing two affiliated entities only where it can be shown that one entity is the "alter ego" of the other. 60 Cal. App. 4th at 257-58. The court rejected the argument that a lawyer is deemed to be representing a corporate parent of another corporation simply by virtue of the parent corporation's status as a shareholder of its subsidiary. *Id.* at 255. Even though the parent/shareholder will suffer some adverse consequence if its subsidiary (including a wholly-owned subsidiary) gets a negative result in a lawsuit, the court adopted

the State Bar's and the ABA's view that such an adverse consequence is "indirect," rather than "direct," "'since its immediate impact is on the affiliate, and only derivatively upon the client.'" *Id*. at 256 (quoting ABA Formal Ethics Op. No. 95-390 at p. 25 and State Bar Formal Op. No. 1989-113 at p. 3).

Accordingly, under *Brooklyn Navy Yard*, two affiliated entities will be treated as the same entity for conflict-of-interest purposes only in the limited circumstance where one is considered the "alter ego" of the other. The court described the alter ego test (which more commonly had been used for purposes of avoiding fraud in the context of debt collection) as follows: "(1) there is such a unity of interest that the separate personalities of the corporations no longer exist; and (2) inequitable results will follow if the corporate separateness is respected." *Id*. at 257-58. It relied on the same factors generally relied upon in the fraud context. *Id*. at 258 (listing factors, including "inadequate capitalization, commingling of funds and other assets, disregard of corporate formalities . . . , identical ownership in the two entities, and identical directors and officers" (citing *Associated Vendors, Inc. v. Oakland Meat Co.*, 210 Cal. App. 2d 825, 838-40 (1962))).

Although *Brooklyn Navy Yard* remains good law, the somewhat broader rule applied in the *Morrison Knudsen* case—decided two years later by the First Appellate District, Division Four—is more frequently cited and applied. *Morrison Knudsen* expressly rejected the alter ego test as being too restrictive, opting instead for a more circumstantial test often referred to as the "unity of interest" test. 69 Cal. App. 4th at 252-53. In rejecting the alter ego test, the *Morrison Knudsen* court pointed out that many of the factors considered by the *Brooklyn Navy Yard* court, and other courts applying the alter ego analysis, were irrelevant to the issue of conflict of interest. For example, the court noted that whether or not a subsidiary was undercapitalized had "little or no bearing on whether [the two companies] should be treated as one entity for purposes of attorney conflicts of interest." *Id*. at 250-51.

In performing the unity-of-interest analysis, *Morrison Knudsen* found the following factors indicated that the two affiliated entities before it (there, a parent and subsidiary) should be treated as one for conflict of interest purposes: (1) the parent controlled the legal affairs of the subsidiary; (2) the two entities had "integrated operations and management personnel"; and (3) the matters at issue for each entity were covered by the same insurance policy. *Id*. at 245-47. In addition, and perhaps most significant to the court, the lawyer had obtained confidential information from the parent entity that was "substantially related to the present claim against the subsidiary." *Id*. at 245; *see also* State Bar Formal Op. 1989-113 at p. 4 (finding that a lawyer may owe a duty of loyalty to a non-client (here, the parent) "if the attorney has received confidential information from the nonclient under circumstances which create a reasonable expectation that the attorney has a duty of fidelity to the nonclient"). All of these factors led the court to conclude that the parent and subsidiary should be considered a single entity for conflict-of-interest purposes.

Even after a lawyer, or a court, determines that two entities should be treated as one for purposes of analyzing any potential conflict of interest, that is not the end of the analysis. At that point, Rule 3-310 must be applied to determine if the lawyer may represent one of these entities and at the same time be adverse to the other. Because the two entities are now being treated as a single entity under the analysis, the question facing the lawyer is no different than the question he faces whenever he seeks to take on a representation adverse to a current or former client. If his representation of one of the entities is ongoing, then his duty of loyalty to that client entity precludes him from taking on a representation adverse to that client entity or any affiliated entity with a unity of interest with that client entity. If, on the other hand, his representation of the first entity has concluded (making that entity a former client), then he must decide if the former matter and the contemplated matter are substantially related under Rule 3-310(E).

Needless to say, these are complex issues, but issues on which a lawyer cannot afford to be wrong. As with most conflicts or potential conflicts, however, a lawyer usually can make life easier if he anticipates issues at the beginning of his representation and addresses them in his engagement letter. Thus, when undertaking representation of a corporate entity that has affiliated entities, a lawyer should think about potential future conflicts, and even consider obtaining an advance waiver from one or more of the related entities if he believes he may be in a position down the road to take on a matter that may be adverse to one of the non-client members of the corporate family.

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