

## **ORANGE COUNTY BAR ASSOCIATION**

### **Formal Opinion 2012-01 (Thrust-Upon Conflicts)**

#### **Issue:**

If an attorney's corporate client is acquired or is merged into a larger corporation, and that larger corporation is an adverse party in litigation the attorney is handling for a second client, what are the attorney's ethical obligations following the acquisition or the merger?

#### **Digest:**

1. Whether a conflict of interest has arisen due to the merger will depend upon whether there is a "unity of interests" between the second client and its new parent corporation.
2. Whether a unity of interests exists will depend upon the extent to which the merged corporations' functions – particularly its law departments - are integrated.
3. If a conflict of interests exists, and one or both clients refuse to waive the conflict, the attorney should examine his ethical duties of loyalty and confidentiality.
4. The attorney may withdraw from representing either client if the attorney complies with his ethical duties regarding withdrawal from representation.
5. The attorney may ethically withdraw from representing one client and continue to represent the other if he has not received from the now-former client confidential information that is substantially related to the matter in which representation is ongoing.

#### **Authorities Interpreted:**

Rules 3-100, 3-310(A) & (C), 3-500, and 3-700(A), (B) & (D) of the California Rules of Professional Conduct.<sup>1</sup>

California Business and Professions Code section 6068(e)(1).

#### **Factual Hypothetical:**

Attorney A has represented for ten years, and continues to represent, a small successful biotech company, Small Bio, in patent prosecution matters.<sup>2</sup> Small Bio

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<sup>1</sup> Except where otherwise specified, subsequent citations to "Rule" will refer to the California Rules of Professional Conduct.

<sup>2</sup> Attorney A may have additional obligations under the rules of the Patent and Trademark Office. These rules are not addressed in this opinion.

has a law department consisting of one General Counsel (“GC”) and two other attorneys.

Simultaneously, Attorney A represents Long-Time Client (“LTC”), a fairly large corporation. Attorney A’s primary work for LTC has involved handling patent litigation against Big Bio – a large, multi-national biotech company with many offices and subsidiaries worldwide. The case, *LTC v. Big Bio* (the “Litigation”), is approaching the close of discovery, and summary judgment motions will be filed within the next two months.

Small Bio’s GC has just informed Attorney A that, effective immediately, Small Bio has been acquired by Big Bio in a stock sale and is now a wholly-owned subsidiary of Big Bio. As a consequence of the newly-created parent-subsidary relationship between Big Bio and Small Bio, the acquisition may create a conflict of interest for Attorney A’s continuing representation of LTC against Big Bio in the Litigation. As of this time, none of Big Bio’s confidential information pertaining to the litigation has passed between the newly-merged entities.

Small Bio informs Attorney A that it will continue its operations at its current location, that current management and executives will continue to run Small Bio, and that Small Bio’s GC will continue to represent Small Bio. However, the GC of Small Bio will begin reporting to the General Counsel of Big Bio, and will work under his direction. Small Bio’s GC will not be performing any legal work for Big Bio and/or its affiliates.

What are the ethical issues and obligations Attorney A must consider in addressing the potential conflict of interest with respect to simultaneously representing LTC and Small Bio now that Small Bio is owned by Big Bio?

### **Legal Principles Pertaining to Parent-Subsidiary Conflicts:**

Until 1999, the relevant standard in determining whether a law firm would have a conflict if it took on a representation adverse to a corporate parent of an existing client was whether the parent and subsidiary were “alter egos”, as set forth in *Brooklyn Navy Yard Cogeneration Partners, L.P. v. Superior Court*, 60 Cal. App. 4th 248 (1997). Under the alter ego test, the parent and subsidiary are regarded as separate entities for purposes of conflicts of interest unless the parent and subsidiary are alter egos of each other.

Not long after the *Brooklyn Navy Yard* decision, however, the alter ego analysis set forth in it was rejected by a different California Court of Appeal in the seminal decision, *Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft*, 69 Cal. App. 4th 223 (1999). The *Morrison Knudsen* court pointed out that the alter ego test was not developed to resolve conflicts of interest, and, further, that an alter ego analysis under California law involved the examination of more than fourteen separate factors, many of which were irrelevant to a conflict of interest inquiry. *Id.* at 249-250. *Morrison Knudsen* thus adopted a “unity of interests” test, recognizing that it

may not be a bright-line rule, but expecting that this test “will continue to [be] develop[ed] on a case-by-case basis.” *Id.* at 253.

Despite *Morrison Knudsen’s* repudiation of *Brooklyn Navy Yard*, *Brooklyn Navy Yard* has not been overruled. Thus, the alter ego test for parent-subsidary conflicts still is theoretically viable. However, most California courts follow *Morrison Knudsen’s* unity of interests test to resolve conflicts of interests, which involves an analysis of factors including the following to determine whether the parent’s and subsidiary’s interests are united:

- In work involving one party to the merger, the lawyer received confidential information that was substantially related to the claim against the other.
- The parent controls the legal affairs of the subsidiary.
- There are integrated operations and management, overlapping functions, and personnel – especially important is whether the law departments are integrated.
- The law firm’s relationship with one entity within a corporate family might give the firm a “significant practical advantage” in a case against another entity in the same corporate family.
- The parent and subsidiary were covered by the same insurance policy on the project at issue.

*See, e.g., Morrison Knudsen*, 69 Cal. App. 4th at 247, 253.

These cases arose in the context of disqualification motions. The California Business and Professions Code, however, imposes ethical duties that are much broader than those considered in disqualification. In particular, they include:

- the duty to avoid representation of adverse interests, including in the context of representation of an organization;
- the duty to protect confidential information;
- the duty of loyalty to one’s client; and
- restrictions regarding mandatory and permissive withdrawal from representation.

## Discussion:

### I. Following the Acquisition, Has a Conflict of Interest Arisen between Attorney A's Representation of LTC and His Representation of Small Bio, Now that Small Bio Is a Wholly-Owned Subsidiary of Big Bio?

Rule 3-310(C)(3) provides that “a member shall not, without the informed written consent of each client: ... “[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.”

Attorney A first must determine whether a conflict actually is created when Small Bio becomes a subsidiary of Big Bio. Applying the *Morrison Knudsen* factors to Small Bio and Big Bio as of the date of merger (or shortly thereafter, when Attorney A first learns of it), Small Bio and Big Bio do not appear to have a unity of interests – yet. The physical location of Small Bio remains the same, and Small Bio will continue with its current management. On the other hand, there is some indication that the law departments of Small Bio and Big Bio may become integrated because Attorney A learns that Small Bio's GC now will begin reporting to the GC of Big Bio.

The law departments are not wholly integrated at this time, however, because Small Bio's GC (and not Big Bio's GC) will continue to interface with Attorney A, and Small Bio's GC will not be counseling any other affiliate of Big Bio. Nonetheless, Attorney A should monitor the situation, because in the event the law departments become further integrated in the future, a conflict may arise. For example, although Small Bio's GC reports to Big Bio's GC, the functions are not fully integrated, as Small Bio's GC is not doing any work for Big Bio's GC or other subsidiaries. Moreover, no confidential information regarding the parent has passed to the subsidiary. If Attorney A observes that the circumstances of the merger have changed in a way that now gives rise to a conflict, Attorney A must inform all parties of the conflict. *See* Rule 3-500 (“A member shall keep a client reasonably informed about significant developments relating to the employment or representation.”).<sup>3</sup>

Attorney A should stay informed and continue to evaluate whether any changes in the relationship between Big Bio and Small Bio, and the nature of the confidential information received or strategic advantage gained in the Litigation, could give rise to a conflict.

### II. Assuming a Conflict Exists, Can It Be Waived by Obtaining Informed Written Consent from the Clients?

If Attorney A determines, based on the *Morrison Knudsen* factors, that a conflict of interest exists, then the situation involves a “thrust-upon” or “springing” conflict –

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<sup>3</sup> *See, e.g., Pennwalt Corp. v. Plough, Inc.*, 85 F.R.D. 264, 272 (D.Del. 1980) (federal court allowed firm to withdraw, noting that no conflict yet existed, but that the relationship between the parent and its new subsidiary was evolving in a way that inevitably would create one).

that is, a conflict that Attorney A did not create. To the contrary, Big Bio created the conflict by acquiring Small Bio. Attorney A (and his Law Firm) and LTC are innocents. In *Truck Ins. Exch. v. Fireman's Fund Ins. Co.*, 6 Cal. App. 4th 1050, 1057 (1992), the court granted a motion to disqualify counsel where the law firm created the conflict, and distinguished inadvertent conflicts: "These other decisions, in large part, are based upon the premise that courts should not allow a law firm to profit from a conflict of interest which it created." *Id.* at 1059 (quoting *Gould, Inc. v. Mitsui Min. & Smelting Co.*, 738 F. Supp. 1121 (N.D. Ohio 1990)).

Nonetheless, regardless of who created the conflict, Rule 3-310(C) forbids attorneys from representing clients with adverse interests, unless informed written consent has been obtained from each client. Consent under Rule 3-310(C), however, is only "informed" if the client's decision is made "on the basis of adequate knowledge of the facts and an awareness of the consequences of the decision." *Sharp v. Next Entm't, Inc.*, 163 Cal. App. 4th 410, 430 (2008); Rule 3-310(A). Therefore, Attorney A may attempt to resolve the situation by obtaining informed written consent from both Small Bio and Big Bio, on the one hand, and LTC on the other.

### **III. Assuming a Conflict Waiver Is Unavailable, May Attorney A Withdraw from Representing One Client and Continue to Represent the Other?**

Assuming that Attorney A requests that LTC, Small Bio (and potentially Big Bio as well) sign a waiver, but Big Bio's GC objects and demands that Attorney A withdraw from any further representation of LTC, Attorney A may not continue to represent both clients (*see* Rule 3-310). The next question is: may Attorney A continue to represent one of the two clients, and if so, which one?<sup>4</sup>

In deciding whether to withdraw, and in deciding which client (if any) to continue to represent, attorneys in a thrust-upon conflict situation first must consider whether the conflicting representations are concurrent or successive.

#### **A. Because the Attorney A Simultaneously Represents Small Bio and LTC, the Duty of Loyalty Should Be Examined.**

Due to the Small Bio-Big Bio merger, Attorney A now is concurrently representing two clients with conflicting interests because, at the time Attorney A learns of Small Bio's merger with Big Bio, he is both representing LTC in litigation against Big Bio and advising Small Bio.

Ordinarily, in such a concurrent representation situation, the ethical duty of loyalty governs whether the attorney may (or must) withdraw. In *Flatt v. Superior Court*, 9 Cal. 4th 275, 284 (1994), the California Supreme Court stated, "[t]he primary value

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<sup>4</sup> Unlike some other jurisdictions, California does not have an express exception to the conflict of interest rules in a "thrust-upon" conflict situation. *See* D.C. Rule of Professional Conduct 1.7 (stating that if a thrust-upon conflict arises that was "reasonably unforeseen" at the "outset" of the representations, and that the attorney attempted to obtain conflict waivers and one client refused, the attorney nonetheless may continue to represent the client that provided the waiver).

at stake in cases of simultaneous or dual representation is the attorney's duty – and the client's legitimate expectation – of *loyalty*, rather than confidentiality.” (Emphasis in original). See also *Anderson v. Eaton*, 211 Cal. 113, 116 (1931) (duty of loyalty requires a lawyer “to protect his client in every possible way, and it is a violation of that duty for him to assume a position adverse or antagonistic to his client .... [A lawyer may not assume] any relation which would prevent him from devoting his entire energies to his client's interests.”). *Certain Underwriters v. Argonaut Insurance Co.*, 264 F. Supp. 2d 914, 919 (N.D. Cal. 2003), applied *Morrison Knudsen* to a conflicting concurrent representation situation and emphasized the duty of loyalty owed to each client. See also *CalWest Nurseries, Inc. v. Super. Ct.*, 129 Cal. App. 4th 1170, 1174-76 (2005) (discussing concurrent representation principles under Rule 3-310(C) in circumstances other than those in *Morrison Knudsen* and *Brooklyn Navy Yard*).

Where an attorney must choose between an *existing* client and a *prospective* client from whom she had obtained confidential information, the California Supreme Court has stated that, “so inviolate is the duty of loyalty to an existing client that *not even by withdrawing from the relationship* can an attorney evade it.” *Flatt*, 9 Cal. 4th at 288 (emphasis added). The *Flatt* Court found no liability for malpractice because the attorney had no duty to inform the prospective client of the impending statute of limitations in a potential lawsuit against an existing client of the firm – in fact, the attorney's duty of loyalty to the existing client forbade her from giving this information. The court noted that withdrawal from representing the prospective client was mandatory under the circumstances. *Id.* at 289-91. The Court noted, however, that the duty of loyalty would not require the same result (*i.e.*, withdrawal from the later-retained client) where – as in Attorney A's case - the attorney had devoted substantial resources to both clients. *Id.* at 290, n.6.<sup>5</sup>

Another factor in evaluating whether the duty of loyalty permits Attorney A's withdrawal from one client and his continued representation of the other is the so-called “hot potato rule,” which bars “curing dual representation conflicts by the expedient of severing the relationship with the preexisting client.” *Flatt*, 9 Cal. 4th at 288. Courts may consider an attorney's knowledge of the conflict prior to undertaking the adverse representation. See *Truck Ins. Exch.*, 6 Cal. App. 4th at 1057 (“a law firm that knowingly undertakes adverse concurrent representation may not avoid disqualification by withdrawing from the representation of the less favored client before hearing.”). In this case, Attorney A did not “knowingly” undertake such adverse representation. However, to the extent Big Bio is larger and

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<sup>5</sup> Compare *Gould* 738 F. Supp. at 1127 (acknowledging that a law firm that “acquired” a conflict of interest when a company acquired its preexisting client could withdraw from *either* the preexisting client and its new parent, *or* the new parent's litigation adversary, whom the firm also represented) with *Cascades Branding Innovation, LLC v. Walgreen Co.*, No. 11 C 2519, 2012 U.S. Dist. LEXIS 61750 (N.D. Ill. May 3, 2012) (considering the importance of the transfer of confidential information in the context of a prospective client negotiation, and concluding that a law firm was disqualified from representing a long time client because the adverse prospective client had provided confidential information that pertained to its core litigation strategies).

potentially more lucrative than LTC, Attorney A should take care to assess its ethical obligations to each client (such as the ethical requirements for withdrawal, discussed below) and not simply drop LTC to appease Big Bio.

**B. Attorney A Also Should Consider the Duty of Confidentiality.**

Therefore, while the duty of loyalty may permit – or even require – an attorney in a thrust-upon conflict situation from withdrawing from representing one or both clients, the attorney also should examine his or her ethical duty of confidentiality

In a thrust-upon conflict situation in which the attorney has withdrawn from representing one client but continues to represent the other, the successive representation rules may apply. *See Truck Ins. Exch.*, 6 Cal. App. 4th at 1057. These successive representation rules dictate that the attorney may continue to represent one of the clients, but only if his representation of that client is not substantially related to his representation of the client from whom he has withdrawn.

*Truck Insurance Exchange* dealt with a concurrent representation situation due to a conflict that was known to the attorney from the outset – that is, *Truck Insurance Exchange* is not a thrust-upon conflicts case.

Despite this, the court opined that:

When counsel, upon discovery and absent consent, immediately withdraws from a concurrent adverse representation, the proper disqualification standard is expressed in the former representation rule. Otherwise, to require disqualification for the *mere happenstance of an unseen concurrent adverse representation* – where the representations are not substantially related and client confidences are not endangered – would unfairly prevent a client from retaining counsel of choice and would penalize an attorney who had done no wrong.

*Id.* at 1058 (first emphasis added).

Consequently, if Attorney A withdraws from representing Small Bio (now Big Bio's subsidiary), and if Attorney A seeks to continue to represent LTC in the Litigation against Big Bio, *Truck Insurance Exchange* suggests, and we agree, that the attorney's ethical obligations should be the same as in a successive representation situation because this was a thrust-upon conflict for Attorney A.

The primary ethical duty implicated in a successive representation conflict is that of confidentiality. *Flatt*, 9 Cal. 4th at 283. Rule 3-100 bars disclosure of confidential client information (as defined by California Business and Professions Code section 6068(e)(1)) without client consent.

When a former client seeks to disqualify an attorney from representing a successive client with adverse interests, the question is whether there is a “substantial relationship” between the two matters. *See, e.g., Flatt*, 9 Cal. 4th at 283; *Morrison*, 69

Cal. App. 4th at 230. This “substantial relationship” test requires an examination of the similarity (or lack thereof) of the factual and legal issues involved in the successive matters, the extent of the attorney’s involvement, and whether the attorney received confidential information about the former client that could give its adversary a “significant practical advantage” against it. *Morrison Knudsen*, 69 Cal. App. 4th at 234, 237, 253.

Thus, in *Morrison Knudsen*, the court found that the attorney who represented the parent corporation (Morrison Knudsen) had received sufficient confidential information regarding the potential liability of subsidiary Centennial that he was barred by conflict from later representing the District in its lawsuit against Centennial.

Because Attorney A has only been representing Small Bio, post-merger, for a very short time, and given the present nature of the parent-subsiary relationship, it is unlikely Attorney A has obtained confidential information about Big Bio via Small Bio that could assist him in representing LTC in *LTC v. Big Bio*.

Due to the *thrust-upon* nature of the conflict, as long as Attorney A received no confidential information that is “substantially related” to the litigation or would give LTC a “significant practical advantage” against Big Bio, and as long as Attorney A complies with all the ethical duties described above, we conclude that Attorney A may be ethically permitted to continue to represent LTC. If, however, Attorney A has received from Small Bio information about Big Bio that is substantially related to the Litigation, Attorney A must withdraw from representing LTC in the Litigation.

In all, there is a possibility that the “thrust-upon” conflict could be viewed as a concurrent one requiring per se disqualification. However, since a “thrust-upon” conflict situation involves the competing interests of “innocent” parties, we believe that *Truck Insurance Exchange’s* reasoning is not only correct, but also provides the best articulation of an attorney’s ethical obligations when facing a “thrust-upon” conflict dilemma.

### **C. Duty To Abide by Ethical Rules Pertaining To Withdrawal from Representation.**

If Attorney A decides to withdraw from representing Small/Big Bio, or LTC, or both, Rule 3-700(A) & (B) applies.

Thus, in addition to requiring that attorneys comply with any court rule that requires permission to withdraw, Rule 3-700(A)(2) states that, “a member shall not withdraw from employment until the member has taken reasonable steps to avoid reasonably foreseeable prejudice to the rights of the client.” According to this Rule, these steps include, “giving due notice to the client, allowing time for employment of other counsel, complying with Rule 3-700(D) [regarding return of client papers and property], and complying with applicable laws and rules.”



The *Flatt* Court recognized that, if a conflict arises between two clients for whom the attorney has devoted “considerable time and... substantial resources,” the attorney should consider the risk of substantial prejudice to the client before withdrawing. 9 Cal. 4th at 290, n.6.

*LTC v. Big Bio* is approaching the dispositive motions phase and trial. Assuming Attorney A wished to withdraw from representing LTC in the Litigation, as Big Bio demanded, Attorney A may have difficulty obtaining the court’s permission to do so.

By contrast, Attorney A’s representation of Small Bio is in patent prosecution matters. Although it is not in a pending litigation matter, there may be upcoming deadlines associated with any patents to be filed with the Patent and Trademark Office.

#### **IV. Conclusion.**

Assuming a conflict of interest is created for Attorney A due to Big Bio’s acquisition of Small Bio on the one hand, and Big Bio’s litigation against LTC, on the other, and assuming Attorney A cannot obtain informed written consent waivers to address this conflict:

- Attorney A may withdraw from representing either LTC or Big Bio if he complies with his ethical duties regarding withdrawal from representation; and
- Attorney A may ethically withdraw from representing one client and continue to represent the other if he has received no confidential information from the now-former client that is substantially related to the matter in which representation is ongoing.

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