Ethics and Corporate Conflicts

By Lisa Perrochet

Thomas Paine said, "The harder the conflict, the more glorious the triumph." But he obviously wasn't talking about ethics conflicts and navigating through the California Rules of Professional Conduct, where hard conflicts create anxiety, lost business opportunities-and sometimes professional liability. Lawyers have to make tough calls about whether the law permits them to concurrently represent what appear to be only indirectly adverse interests, and about when preserving relations with existing clients warrants forgoing retention even if no actual conflict exists within the meaning of the rules on ethics. Little glory there.

Rule 3-310 of the California Rules of Professional Conduct (Avoiding the Representation of Adverse Interests) provides that a lawyer may not "represent 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."

But the meaning of "adverse" is far from clear in this context. Obviously, when a lawyer or firm represents opposing parties in a single action, it violates Rule 3-310 and the duty of loyalty. (*See Flatt v. Superior Court*, 9 Cal. 4th 275, 287 (1994).)

The Comments to Rule 3-310 make clear, however, that not every "divergence" of interests will create an impermissible conflict. For example, the Comments state that the rule is not intended to prohibit a lawyer "from representing parties having antagonistic positions on the same legal question that has arisen in different cases, unless representation of either client would be adversely affected." In other words, "issues" conflicts generally don't count unless, for example, you are inclined to weaken the zealous advocacy of client A's position on an issue to enhance client B's chances of success on that issue. But if you vigorously pursue conflicting legal positions—such as the meaning of a particular statute—in different actions for different clients, the chips will presumably fall where they may when the issues are decided, and both clients will have been properly represented.

Gray areas lie between the direct conflict of representing opposing parties in a single case and the very indirect conflict of having clients on opposite sides of a purely legal issue. For example, to what extent must a lawyer take into account the indirect interests of parent or subsidiary corporations or other entities affiliated with a represented party, or the indirect interests of an insurer in the outcome of an action to which the insurer is not a party?

Representing One Entity, Opposing Another

In California, corporations and other entities organize in all sorts of complicated ways to take advantage of rules that may limit liability, offer tax advantages, or create other benefits resulting from having separate structures and identities. If established correctly, the corporate form of such entities will be respected. (*See Laird v. Capital Cities/ABC, Inc.*, 68 Cal. App. 4th 727, 737 (1998) and *Berclain America Latina v. Baan Co.*, 74 Cal. App. 4th 401, 407 (1999).)

But in the area of professional ethics, an entity or group of affiliated entities may choose to look past the structure purposefully created, in hopes of limiting, for tactical reasons, the activities of a lawyer for one of the related enterprises. California law is not clear on the extent to which a lawyer's representation of one corporate client creates sufficiently direct adversity—and thus a potentially disqualifying conflict—when he or she represents a party in a different case who is opposing an affiliate of the first client.

In *Brooklyn Navy Yard Cogeneration Partners v. Superior Court* (60 Cal. App. 4th 248 (1997)), a court of appeal reversed a disqualification order, holding that an attorney may represent a defendant in one action brought by a corporate plaintiff and, in unrelated litigation, may simultaneously represent the interests of a corporation that is a subsidiary of the plaintiff in the first action.

The court held that unless the plaintiff corporation in the first action and the subsidiary corporation in the second are alter egos, the attorney cannot automatically be deemed to be representing interests adverse to a current client. It reasoned that only "direct adverse consequences to an existing client" are barred under the ethics rules prescribed by both the California Rules of Professional Conduct and the ABA Model Rules of Professional Conduct. (60 Cal. App. 4th at 256; *see also, Responsible Citizens v. Superior Court*, 16 Cal. App. 4th 1717 (1993).)

In setting out its rationale, the court first noted that it would be difficult to distinguish among levels of indirect adverse impacts when there are varying degrees of corporate affiliation.

Second, the court observed that it would be difficult to screen for conflicts if an attorney must look beyond the named parties to litigation to find affiliated entities that may be related to a current client of the attorney. That is especially true in this time of corporate mergers and takeovers. It would be a daunting task to keep a firm's conflicts database current, noting every entity that may be affiliated to one degree or another with a prospective client or opposing party.

In reaching its result, the appellate court in *Brooklyn Navy Yard* disapproved the trial court's use of a "unity of interest" standard in deciding whether affiliated entities could be deemed to have directly related interests giving rise to disqualification under the circumstances in that case.

Two years later, however, a different appellate panel approved some form of a "unity of interest" test. In *Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft* (69 Cal. App. 4th 223 (1999)), the court explained in great detail why a "unity of interest" test might be right for determining conflicts from representation of affiliated corporations. The problem is, no court has adequately defined the "unity of interest" test.

In *Morrison Knudsen*, a corporation and its wholly owned subsidiary sought to disqualify a law firm from representing a water district in a dispute with the subsidiary concerning a road construction project. The firm had never actually represented the subsidiary, but it had represented the interests of the parent corporation and its insurers, which retained the firm to monitor other attorneys representing the corporation on errors and omissions claims.

The trial court granted disqualification, and the court of appeal affirmed. Although there was no "direct" conflict of interest, the firm had monitored some cases for the parent corporation and so was privy to information about the parent corporation's financial condition that could be useful to an adversary. Moreover, given the overlap of functions and personnel between parent and subsidiary, especially in legal affairs, the trial court found they were closely enough related to be treated as one entity in determining the firm's conflict of interest.

Morrison Knudsen could have been resolved based on Rule 3-310(d)'s mandate that a lawyer shall not, without a client or former client's informed written consent, accept employment adverse to it when, "by reason of the representation of the client or former client" he or she "has obtained confidential information material to the employment." Cases have explained that this rule—based on the duty of confidentiality, independent of the duty of loyalty—precludes a lawyer's involvement on behalf of a party adverse to a current or former client in a matter "substantially related" to representation of the current or former client. (*See Flatt v. Superior Court*, 9 Cal. 4th at 28384).)

Because the firm in *Morrison Knudsen* arguably had access to client confidences that might assist its new client, the water district disqualification might have been appropriate on that basis alone. But the court seemed to base its decision at least partially on the independent duty of loyalty embodied in subdivision (c) of Rule 3-310, and in that respect it parted company with *Brooklyn Navy Yard*.

Ironically, a corporation attempting to disqualify counsel under *Brooklyn Navy Yard* or *Morrison Knudsen* will essentially be attempting to pierce its own corporate veil, to blur the distinction between different entities that was presumably set up with care to be preserved in other contexts.

Only one published opinion to date discusses *Brooklyn Navy Yard* and *Morrison Knudsen*, and that opinion—*California West Nurseries v. Superior Court* (129 Cal. App. 4th 1170 (2005))—distinguishes both in a way that does nothing to resolve the conflict between the earlier two decisions.

In that case, the same court that decided *Brooklyn Navy Yard* reviewed a disqualification order in which a firm represented a nursery as a defendant in one action and later was associated into an action to defend another corporation that filed an indemnity cross-complaint against the nursery. The firm attempted to remain as counsel for both clients by limiting its representation to matters that would not implicate the cross-claims between the parties. In doing so, the firm relied on both *Brooklyn Navy Yard* and *Morrison Knudsen* as authority for the proposition that any adversity between its two clients was merely indirect.

That argument was unsuccessful. The court concluded instead that, because the firm's two clients—opponents in the same action—were directly adverse with respect to their cross-complaints, "it is plain that the issue of direct versus indirect opposition does not bear on the facts of this case." (129 Cal. App. 4th at 117677; *see also,* ABA Opinion 95-390 (1995) [a majority of committee members concluded a parent/subsidiary relationship should not automatically disqualify a lawyer from a representation adverse to an affiliated entity, but a minority would adopt a contrary bright-line rule].)

In sum, it appears that representing one entity won't necessarily preclude an attorney from representing adverse interests of a parent, subsidiary, or other affiliated entity. However, before undertaking such representation, you should ascertain whether the entities have maintained separate structures so that representing one, with the concomitant duty of loyalty, does not translate into an attorney/client relationship with the other. You should also assess whether representing one client would inferentially give you access to "corporate family" confidences that might be useful in the adverse representation

Insurers and Insureds
After State Farm

The same year that *Morrison Knudsen* was decided by the First District Court of Appeal, the Fifth District decided *State Farm Mutual Automobile Ins. Co. v. Federal Ins. Co.* (72 Cal. App. 4th 1422 (1999)). It held that an attorney must be disqualified from simultaneously defending an insurance company's insured in one action-in which the lawyer owes duties to both the carrier and the insured in a "tripartite" relationship-while prosecuting another action directly against the company.

The court focused on the fact that the attorney had an attorney/client relationship with the carrier by virtue of having been retained to represent the insured. It held that the attorney's lawsuit against the carrier was adverse to an existing client.

In response to concern that the *State Farm* opinion might be expanded beyond the facts of that case, a Comment to Rule 3-310 was inserted to explain that the rule "is not intended to apply with respect to the relationship between an insurer and a [lawyer] when, in each matter, the insurer's interest is only as an indemnity provider and not as a direct party to the action." This comment is consistent with the *Brooklyn Navy Yard* rule that only "direct" conflicts create a concurrent representation problem.

Accepting representation of interests adverse to a client carrier's insured in one action while representing a different insured of that carrier in another action is not undertaking representation "directly" adverse to the carrier. As outlined in *Brooklyn Navy Yard* with respect to parent/subsidiary relationships, there are varying degrees to which an insurer may be exposed to paying for an insured's potential liability. If, for example, the carrier has a strong defense against the insured's claim for coverage, it is only remotely likely that the attorney's success against the insured will negatively affect the insured's carrier.

Similar to the difficulty posed in identifying all affiliated entities when accepting retention adverse to a corporate entity, it would be arduous for an attorney, especially at the outset of litigation, to identify all of the possible insurers who may owe coverage to an adverse party. Indeed, the parties themselves may not initially know which insurance applies. The attorney who agrees to represent one party therefore could not reliably determine whether another party in the matter will turn out to have coverage from a carrier that is a current client of the attorney. The practical problems identified in *Brooklyn Navy Yard* thus support a rule limiting disqualification as a result of representing interests indirectly adverse to an insurer that the lawyer represents in unrelated litigation.

Thus far, however, no published opinion governs circumstances that fall neither squarely within the *State Farm v. Federal* fact pattern (where a lawyer is prohibited from representing a plaintiff in an action against an insurer defendant who is the lawyer's client as a party in another matter) nor within the safe harbor described in the comment to Rule 3-310 (permitting a lawyer to represent an insurer's interests in one matter while representing a party whose interests are indirectly adverse to the insurer in another matter when the insurer is not a party in either action).

Future cases will indicate whether *State Farm v. Federal* will require disqualification of an attorney who represents a carrier as the party in one case while also representing interests adverse to the carrier's in an unrelated action. If so, such a ruling may exacerbate the problem of tactical disqualification motions filed by a client who has no real concern that its lawyer will have an impaired duty of loyalty that interferes with zealous advocacy of the client's interest. Such a client may nonetheless seek to deprive an opposing party of competent counsel, or at least to cause the opposing party to go through the hassle and expense of finding new counsel.

Trial courts facing this question should be mindful of the supreme court's admonition in *People ex rel. Dept. of Corporations v. SpeeDee Oil Change Sys., Inc.* (20 Cal. 4th 1135 (1999)) that disqualification motions may involve considerations including a client's right to chosen counsel, an attorney's interest in representing a client, the financial burden on a client to replace disqualified counsel, and the possibility that tactical abuse underlies the disqualification motion. As a consequence, "judges must examine these motions carefully to ensure that literalism does not deny the parties substantial justice." (20 Cal. 4th at 1144.)

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