

TROUBLED COMPANIES AND TROUBLING ETHICAL ISSUES:

**A PROACTIVE APPROACH FOR THE AVOIDANCE
OF POTENTIAL MALPRACTICE LIABILITY**

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Given the current global economic conditions, particularly the stagnation of consumer spending and the dearth of available credit, it comes as no surprise that businesses are more and more frequently facing the inevitability of restructuring proceedings. Indeed, the online magazine *Salon* recently consecrated a virtual and ever-expanding graveyard of “brands” that have succumbed to the global financial crisis.¹ While only four plots have been dug so far,² the magazine encourages readers to send suggestions for additional internees while simultaneously maintaining a list of high-profile companies currently in “ICU” and thus presumably knocking on death’s door.

Ironically, these dire economic conditions present to certain transactional attorneys a wealth of new business opportunities as troubled companies attempt to shed cash-strapped or unprofitable subsidiaries, create liquidity through intra-corporate asset transfers, and – for the most unfortunate – enter into bankruptcy. At the same time, however, these opportunities carry with them significant risk: A recent article in the *National Law Journal* forecasts a “surge” in legal malpractice lawsuits over the next several years, as clients attempt to recoup losses from *any* relatively deep-pocketed third

¹ Salon.com, *The Brand Graveyard*, at http://www.salon.com/news/brand_graveyard.

² The four bankruptcies currently featured are those relating to the Rocky Mountain News, Fortunoff, Mervyn’s, and Circuit City.

parties against whom they might have a claim.³ Of particular concern to a growing number of law firms are suits brought by bankruptcy trustees, which are often better funded and better lawyered than those typically brought by shareholders seeking to establish derivative liability for securities fraud,⁴ and which additionally do not face the same threshold barriers to liability that have been imposed by the Supreme Court under the Securities and Exchange Act of 1934.⁵

One area of potential malpractice liability concerns the proper legal advice that attorneys should give to corporations (i.e., their officers and directors) with respect to the fiduciary duties imposed upon them when their companies have not yet become insolvent but have nonetheless entered the ever-shifting “zone of insolvency.” Although Delaware has recently affirmed that such officers and directors remain fiduciaries of the shareholders rather than the creditors of the corporation,⁶ other states courts have yet to provide such “definitive guidance.”⁷ Consequently, a lawyer advising a corporate board with respect to certain risky transactions – i.e., those that, if successful, would greatly

³ Karen Sloan, *Legal Malpractice Suits May Surge*, NAT'L L.J. (Feb. 23, 2009), available at <http://www.law.com/jsp/article.jsp?id=1202428510900> (last visited Mar. 6, 2009).

⁴ See Amanda Bronstad, *Firms Fend Off More Malpractice Actions as Failed Deals Fuel Suits*, NAT'L L.J. (Apr. 1, 2008), available at <http://www.law.com/jsp/article.jsp?id=1206960391480> (last visited Mar. 6, 2009); Anthony Lin, *Bankruptcy Trustee Suits Cause Increasing Concern for Law Firms*, N.Y.L.J. (Nov. 27, 2007), available at <http://www.law.com/jsp/article.jsp?id=900005561422> (last visited Mar. 6, 2009).

⁵ See *Stoneridge Invest. Partners v. Sci.-Atlanta, Inc.*, 128 S.Ct. 761 (2008) (holding that § 10(b) does not permit investors to maintain a civil action against third-parties who actively participated in a scheme to inflate a public corporation's stock price where those third-parties made no public statements upon which the investors relied); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1993) (holding that § 10(b) liability does not extend to aiding and abetting a violation).

⁶ See *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 202-03 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. Supr. 2007) (table).

⁷ See, e.g., *In re Total Containment, Inc.*, Bankr. No. 04-13144bf, 2008 WL 682455, at *9 (Bkrcty. E.D. Pa. Mar. 5, 2008) (“Although [the tort of ‘deepening insolvency’] has not been accepted in all jurisdictions, the Third Circuit Court of Appeals has predicted that Pennsylvania's Supreme Court will recognize it.” (citing *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 349 (3d Cir. 2001) (additional citation omitted)); *In re Joy Recovery Technology Corp.*, 286 B.R. 54, 81 (Bkrcty. N.D. Ill. 2002) (“Although, this court [has] opined that the fiduciary duty owed by directors of a corporation may protect creditors when a transaction undertaken by the corporation at direction of its officer leads to insolvency, that view has been criticized as overly broad . . . [and] [a]t present the Illinois Supreme Court has not resolved this issue.”).

benefit shareholders, but, if not, would render the entity substantially less capable of repaying its debts – may at most be able to provide tentative advice that, if incorrect, could expose both him and his client to potential liability. Indeed, this appears to have been at the heart of recent litigation filed by the Chapter 11 trustee of Saint Vincent’s Catholic Medical Centers against McDermott, Will & Emery, in which the trustee sought more than \$200 million in damages for legal malpractice, breach of fiduciary duties, and fraud.⁸

Leaving this unsettled area of the law aside, a far more intractable ethical dilemma faces counsel advising corporate conglomerates in which the interests of the parent become adverse to one or more subsidiaries for which the attorney had previously been serving as counsel, whether formally or only in a *de facto* capacity.⁹ Consider, for example, the following hypothetical posed by John K. Villa, a partner at Williams & Connolly LLP who has defended a number of law firms in high-profile malpractice actions:

⁸ See Anthony Lin, *Bankruptcy Trustee Sues McDermott Will for Malpractice*, N.Y.L.J. (Apr. 17, 2008) (“The [] complaint . . . alleges McDermott Will put off a much-needed Chapter 11 filing to facilitate self-dealing by two other members of the hospital group’s restructuring team. As a result of the delay, the trustee claims, Saint Vincent’s incurred greater operating losses, paid more professional fees and took longer to emerge from bankruptcy after it finally did file.”), available at <http://www.law.com/jsp/article.jsp?id=900005561422> (last visited Mar. 6, 2009).

⁹ It is fairly well-settled that a lawyer for a corporate client does not thereby represent corporate affiliates of that client except in limited situations or by express agreement of the lawyer. See, e.g., ABA Model Rules of Professional Conduct Rule 1.7 cmt. 34 (1983) (“A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary.”); ABA Formal Opinion 95-390 (1995).

At the same time, however, common representation of all members of the “entire corporate family” is standard practice, even in the absence of formal representation agreements. See, e.g., Amicus Curiae Brief of the Ass’n of Corporate Counsel, *In re Teleglobe Communications Corp.*, 493 F.3d 345 (3d Cir. 2007) (No. 06-2915), at 5. As the ACC explains, “It is normal practice for in-house lawyers to advise (often multiple) affiliated companies within the corporate group, because this practice is a wise and economical husbanding of resources, because it assures coordinated counseling and increased compliance between related entities, and because it almost always enhances the quality (and in some cases, the very existence) of legal services provided to subsidiaries that otherwise might not have the resources or experience with complex regulation and business practices to afford their own counsel.” *Id.*

The general counsel directs you to prepare a memorandum on the question of whether the parent corporation should sell one of its subsidiaries or dump it into bankruptcy. “And don’t breathe a word of this to the sub’s management until we figure out what to do with it,” you are told. The sub is hemorrhaging cash; it has potential liabilities from a judgment in a tort case; and it has been a chronic compliance problem. As you begin your analysis of the issue, you receive calls from the sub’s management asking for advice on how to deal with the tort judgment and ongoing compliance problems, and you begin to feel uncomfortable. Should you?¹⁰

Villa suggests that a recent opinion by the Third Circuit Court of Appeals, *In re Teleglobe Communications Corp.*,¹¹ “may provide [] a roadmap on how to avoid the most serious problems lurking [in the hypothetical],” but while *Teleglobe* thoroughly analyzes thorny issues of attorney-client privilege that arise when a lawyer represents both a parent and a subsidiary whose interests become adverse, it only addresses in passing the ethical dilemma facing the lawyer placed in such situation. Specifically, the *Teleglobe* court merely cites (without additional commentary or analysis) to the *Restatement (Third) of the Law Governing Lawyers* for the proposition that a joint attorney must end joint representation when he perceives his clients’ interests “diverging to an unacceptable degree.”¹²

Unfortunately for Villa’s hypothetical practitioner, the *Restatement* itself does not provide much guidance. It prohibits a lawyer, absent effective consent, from representing a client if the representation would involve a “conflict of interest,” i.e., “a substantial risk that the lawyer’s representation of the client would be materially and adversely affected by the lawyer’s own interests or by the lawyer’s duties to another current client, a former

¹⁰ John K. Villa, *The Attorney-Client Privilege in the Parent-Subsidiary Context*, ACC DOCKET (Dec. 2007), at 76, 76, available at http://www.wc.com/assets/attachments/attorney_client_privilege.pdf (last visited Mar. 6, 2009).

¹¹ 493 F.3d at 345.

¹² *Id.* at 368 (citing RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 121 cmts. e(1)-(2)).

client, or a third person.”¹³ In the commentary, the *Restatement* authors attempt to elaborate on this standard by restating it in the following manner: a “conflict of interest” arises when there is (1) “more than a mere possibility” (or “substantiality”), (2) based on “facts and circumstances that the lawyer knew or should have known at the time of undertaking or continuing a representation” (or “objectivity”), that (3) a conflicting interest will decrease the “quality of the [lawyer’s] representation” (or “adverseness”), (4) “by reference to obligations necessarily assumed by the lawyer, or assumed by agreement with the client” (or “materiality”).¹⁴

The *Restatement* purports that this standard is “reasonably susceptible of objective assessment by lawyers subject to the rules, by clients whom the rules affect, and by tribunals,”¹⁵ and indeed explicitly rejects an alternative “appearance-of-impropriety standard” as incapable of being given “objective content.”¹⁶ Yet the *Restatement* simultaneously cautions that “[w]hether there is adverseness, materiality, and substantiality in a given circumstance is often dependent on specific circumstances that are ambiguous and subject of conflicting evidence” and further notes – lest this were not enough – that “cases that carefully articulate the proper conflict-of-interest standard are rare.”¹⁷ The ABA Rules of Professional Conduct provide equally little definitive guidance. Rule 1.7 prohibits an attorney, absent effective consent, from representing a

¹³ RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 121.

¹⁴ *Id.* § 121 cmt. c (cross-reference omitted).

¹⁵ *Id.*

¹⁶ *Id.* § 121 Reporter’s Note cmt. c(iv).

¹⁷ *Id.* § 121 cmt. c & Reporter’s Note cmt. c. Despite this lack of clarity, the *Restatement* advises lawyers to implement “reasonable procedures appropriate for the size and type of and practice, to detect conflicts of interest” and warns that their failure to do so may subject them to disciplinary sanctions, disqualification, legal malpractice suits, and/or fee forfeitures. *Id.* § 121 cmts. f, g; *see also* Nancy J. Moore, *Conflict of Interest for In-House Counsel: Issues Emerging from the Expanding Role of the Attorney-Employee*, 39 S. TEX. L. REV. 497, 498 (1998) (“As one of the most litigated areas of professional responsibility, lawyer conflicts are now being raised as a basis for such diverse remedies as civil damages, disqualification, and fee forfeiture, as well as the more traditional remedy of professional discipline.”).

client if the representation would involve a “concurrent conflict of interest.” The Rule then specifies that a “concurrent conflict of interest” arises either (1) where “the representation of one client will be directly adverse to another client” (i.e., the obvious cases of potentially disqualifying conflict), or (2) where “there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client” (i.e., in terms of the *Restatement*, where there is “substantiality,” “adverseness,” and “materiality”).¹⁸ This lack of clarity has led at least one commentator to complain that the law of conflict-of-interest rules in the context of corporate affiliates is “unsettled and poorly articulated,” “employ[ing] misleading terminology and [] characterized by the absence of a reasonable general rule.”¹⁹

So what should Villa’s hypothetical practitioner do? Villa himself suggests that he remain particularly cognizant of certain corporate transactions likely to give rise to a conflict (e.g., the potential sale of a subsidiary, or a transaction where the subsidiary may voluntarily petition or be forced into bankruptcy) but otherwise just to follow his gut and consult legal ethics specialists whenever any particular “tension between the interests of corporate family members” is “perceive[d].”²⁰

Following this advice, while undoubtedly sound, may be insufficient to avoid the anticipated volume of trustee-initiated malpractice litigations over the next several years. But recognizing which corporate transactions are most likely to give rise to a conflict of

¹⁸ See ABA Model Rules of Professional Conduct Rule 1.7 (1983). Note the similarity between the *Restatement* conflict-of-interest standard and ABA “non-direct” conflicts-of-interest standard: both embrace notions of substantiality, adverseness, and materiality, although the ABA standard is silent as to objectivity.

¹⁹ John Steele, *Corporate Affiliate Conflicts: A Reasonable Expectations Test*, 29 W. ST. U. L. REV. 283, 283-85 (2002). Another commentator has noted that, under the ABA rules, “[w]henver a common attorney represents both an organization and an individual constituent in the same matter, it will *almost* always be the case that the representation of one may be ‘materially limited’ by the attorney’s responsibilities to the other.” Moore, *supra* note 17, at 515 (emphasis added).

²⁰ Villa, *supra* note 10, at 81.

interest, so that potential ethics problems can be identified and addressed early on, is a crucial first step to reducing the risk of liability for legal malpractice. For example, in addition to those mentioned above, any transaction in which a cash-starved parent transfers liquid assets from its subsidiaries to itself is likely to give rise to a conflict of interest requiring separate legal representation. By identifying clearly ascertainable, problematic transactional scenarios such as these well in advance,²¹ lawyers can prime themselves to give a hard second-look at potential conflicts-of-interest early in the representation of troubled companies, enabling them – where necessary – to retain separate “conflict counsel” before substantial ethical complications (and the exposure to liability that they entail) have arisen.

²¹ For an example of the tensions that potentially arise among members of a multinational corporate family, see Sixth Report of the Monitor, *In re InterTAN Canada Ltd. et al.*, Ontario (Canada) Superior Ct. No. CL 08-7841 (filed March 2, 2009), which is included in the program materials.