1973

Conflicts of Interest in Corporate Law Practice

Stanley A. Kaplan

OCCASIONAL PAPERS

FROM THE LAW SCHOOL

THE UNIVERSITY OF CHICAGO

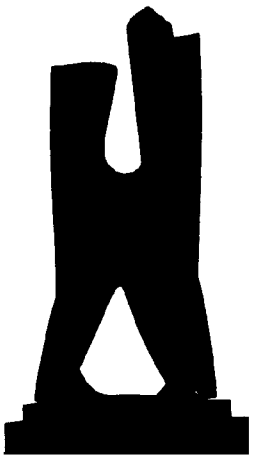
NO. 4

1973

Occasional Papers
from
THE LAW SCHOOL
THE UNIVERSITY OF CHICAGO

Conflicts of Interest in Corporate Law Practice

By STANLEY A. KAPLAN



Conflicts of Interest in Corporate Law Practice

By STANLEY A. KAPLAN

This presentation by Stanley A. Kaplan, Professor of Law at the University of Chicago, was delivered at the Third Annual Securities Law Institute of the Practicing Law Institute held on November 5, 1971 in New York City and is reprinted with permission. It should be noted that this was prior to the filing of the widely-known complaint in *SEC* v. *The National Student Marketing Corp.*, Civil No. 225-72 (B.D.C. filed February 3, 1972). The text of the complaint is set forth in BNA Securities Regulation & Law Report No. 138, page D-1 (February 9, 1972) and in CCH Federal Securities Law Reporter (current) ¶ 93,316 (1972). It should also be noted that the case of *Kohn v. American Metal Climax, Inc.*, discussed herein, has subsequently been affirmed and modified on appeal to the Court of Appeals for the Third Circuit, 458 F.2d 255 (1972). The Court of Appeals found that the law firm which had been charged with representing both parent and subsidiary in merger negotiations between them had in fact ceased to have such a dual representation before the negotiations reached a significant point; the Court of Appeals did not say anything further concerning the remarks of the District Judge on this point, which are quoted and discussed herein. Other participants in the discussion are Robert H. Mundheim, Arthur Fleisher, Jr., and Philip A. Loomis, Jr.

Conflicts of Interest in Corporate Law Practice

By Stanley A. Kaplan

I. THE CODE OF PROFESSIONAL RESPONSIBILITY

I think our starting point has to be the Code of Professional Responsibility which the American Bar Association adopted in 1969[1] and which has been adopted in practically all states since then.

In addition to that, I think we have to take note of the fact that most of the recent lay publications with respect to lawyers that I have read in the last couple of years have been tinged with increasing abrasiveness and have been damning with ever fainter praise the position of the legal community in our society.

The recent *Fortune* articles,[2] some of the comments of our more prominent judges, and recent publications that I have seen from some state bar associations indicate that we may be in for a needed self-examination and a much greater self-policing operation than we have had in the practice of law before. Some of it may be less than palatable to a great many of us.

A. Canon 5

You all have available the *Code of Professional Responsibility*, *Canon* 5.[3] And I commend to you that you read with some fascination Ethical Considerations 14 through 18 at your leisure.[4] I think you will find, if you have not read them, as I confess I had

1. The Code of Professional Responsibility was adopted by the House of Delegates of the ABA on August 12, 1969, to become effective for ABA members on January 1, 1970. It was amended by the House of Delegates on February 24, 1970.

2. *E.g.*, Bork, *We Suddenly Feel That Law Is Vulnerable*, FORTUNE (Dec. 1971).

3. "The Canons are statements of axiomatic norms . . . [which] embody the general concepts from which the Ethical Consideration[s] and the Disciplinary Rules are derived." Preliminary Statement to the Code of Professional Responsibility. The current Code is set out in MARTINDALE-HUBBELL Vol. 5 (1972)

4. "The Ethical Considerations are aspirational in character and represent the objective toward which every member of the profession should strive." *Id.*

not until a short time ago, that they lay down some rather serious problems for the lawyer in ordinary corporate practice.

The general position of the Code is that the lawyer is prevented or is prohibited from representing differing interests. The prior Canons of Ethics spoke of not representing conflicting interests.[5] Differing interests, as I read it, is a broader term and, as it is defined in the Code, it includes conflicting interests as well as several other types of potential differences.[6]

In this area of the lawyer's responsibility in corporate practice, there has been very little literature, very few judicial opinions and very few interpretations by the Ethics Committee of the American Bar Association or of the more prominent bar associations in our larger cities. I am not sure whether that fact is attributable to a pristine state of purity or just a failure really to look at the complexities of the situations that the larger corporate practice involves. I rather hope it's the former.

The initial prohibition in the Code against representing differing interests is then somewhat relaxed by saying that the lawyer may not represent conflicting interests if his judgment may be impaired thereby or his loyalty divided. If he decides that this impairment of judgment or division of loyalty will not occur, then he must, before he undertakes dual representation, make full disclosure to all of his clients and obtain their consent. Full disclosure means evaluation of the various kinds of ramifying difficulties that the client may face and the problems that the client ought to consider before permitting duality of representation. The burden is on the lawyer to make the decisions as to whether there are differing interests or whether there is a situation in which his loyalty will be impaired or his judgment affected.

5. See ABA Canon 6, "Within the meaning of the canons, a lawyer represents conflicting interests when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose."

6. EC 5-14 speaks of interests which may be "conflicting, inconsistent, diverse, or otherwise discordant."

B. The Prior Canons of Ethics

One of the comments on the prior Canons of Ethics, which I find of interest, is that of Carl McGowan, now a judge of the Court of Appeals of the District of Columbia, in a conference on this general subject at the University of Chicago Law School held in 1961. He was speaking of the earlier Canons of Ethics and he said:

> "There are some things of interest to note about these paragraphs. The first imposes a duty of full disclosure to prospective clients of any interest in the controversy or the parties thereto. This seems to throw the burden of avoiding the conflict, or at least of approving it, upon the client or prospective client who is fully informed. I would suggest that this is unrealistic. I do not myself believe that it is the client who can best make the decision as to whether it is a harmful conflict, even though he knows all the facts. In most cases the client is going to act upon the basis of his lawyer's opinion on this, as on all other aspects of the legal problem at hand. It is the lawyer's job to see to it that he acts rightly."

In the recent case of *E. F. Hutton & Co. v Brown*,[7] the court similarly said: "The obligation to search out and to disclose potential conflicts is placed on the attorney, in order to put the client in a position to protect himself in obtaining substitute counsel if he so desires."[8]

II. IDENTIFYING THE CLIENT

Judge McGowan was speaking of house counsel because he was then general counsel of the Northwestern Railroad. I think his comments apply equally to outside independent counsel for a corporation. He continued his remarks as follows:

> "However, sometimes it may well be asked in the case of house counsel: Who is the client? Is it the management? Or is it the whole body of stock-

7. 305 F. Supp. 371 (S.D. Tex. 1969).
8. *Id.* at 398.

holders, including any particular group who may not be completely happy at that time with the management? What are the obligations of house counsel with respect to disclosure of information to dissident stockholders, for example? Does he have some obligation in that regard? Or is he to owe a full and undivided loyalty to the people who hired him—existing management, a part of which he is? This problem, you see, can come up in proxy fights, it can come up in stockholders' suits, and I have no solutions to suggest, except to say that I think we may anticipate that there will be a developing body of principles and rules with respect to these situations as their increasing incidence creates a demand for guidance."

The problem of identifying one's actual client is faced by all lawyers in a multitude of corporate situations beginning with the simplest and most basic relationship, *e.g.*, when two brothers come in and ask you to set up a corporation for them. It multiplies and ramifies and becomes more complex as the relationship between counsel and the real parties in interest becomes multiplied, more distant, and more complex.

In the background of this problem of representation of conflicting interests, one significant event which sheds some light was the inquiry into the ethics of Louis Brandeis when he was considered for appointment to the Supreme Court of the United States. In a very interesting discussion of this situation, John Frank[9] discussed the fact that Brandeis had counseled the making of an assignment for the benefit of creditors and then had later moved vigorously to force the assignee to comply with the assignee's obligations under the assignment. This was asserted to be a basis for disqualifying him from appointment for unethical conduct. Frank states as follows:

"A good share of any embarrassment Brandeis suffered over the Lennox case[10] is due to his own use of what must have been one of the most unfortunate phrases he ever casually uttered....

9. Frank, *The Legal Ethics of Louis D. Brandeis*, 17 Stan. L. Rev. 683 (1964).

10. *Id.* at 698-703.

> Whipple reported that when he asked Brandeis for whom the latter was counsel when he advised the assignment, Brandeis replies, 'I should say that I was counsel for the situation.'
>
> "This is a misty phrase which could have meant one thing to Brandeis, another to Whipple, and might mean something else again to today's lawyer. Lawyers are not retained by situations, and the adversary system assumes that they faithfully represent one interest at a time."[11]

In the simple, close corporation context, considerations of expense, expeditious handling, and the dubious belief that a lawyer can fairly represent both sides of the transaction, often lead the lawyer for the corporation to represent both the corporation on one side and a major shareholder or a significant management figure on the other. In that kind of situation, at least the lawyer can get all the concerned people in one room and explain the difficulties to them fully. Even if the lawyer does that, it should be noted that he does not act in the lawyer's usual role. He is not acting as an advocate for one person or as counsel to one person. He is acting as a neutral resource person; his role as counsel is one in which he is emasculated unless, of course, he represents one person rather than the others, in which case he must disclose that and should tell the other persons present that he is not acting for them and that they had better get independent counsel. Though this is often done, I suspect that all of us who have undertaken this kind of representation have probably come to regret it.

In a situation which involves a publicly held corporation, complex transactions, and a large number of stockholders, then, counsel who acts as "attorney for the situation" really faces complicated problems. I think there are a great number of possibilities of injustice to clients and a great number of even more significant problems of embarrassment and difficulty for counsel. Fortunately, we have some comments by a court on this general subject in the *Amax* case,[12] involving a merger between a parent and partially owned subsidiary.

11. *Id.* at 702.

12. Kohn v. American Metal Climax, Inc., 322 F. Supp. 1331 (E.D. Pa. 1970).

III. DERIVATIVE SUITS

Before considering the facts in that case, I would like to discuss a related area, in which we do have a few decisions and some commentary, in order to present some background which I think might be helpful. That is the area of derivative suits in which counsel enters an appearance for the corporation, which is a nominal party defendant, and also enters his appearance for the members of the management who are named as individual defendants. The realities here are that the individual defendants are being sued for liability which, if established, will be paid over to the corporation; the corporation is the ultimate beneficiary.

There have been a number of such cases. The earlier cases seem to suggest that where there was no immediately discernible conflict and, where the corporation's activity in the lawsuit was practically nil, that the concept would not put a serious block in the way of this dual representation. The later cases have indicated a sharply different point of view, in my judgment. In a number of cases, motion has been made by the plaintiff to strike the appearance of counsel for the corporation on the ground that his real loyalties run counter to the corporation and in favor of the individual defendants. In a number of cases, counsel for the corporation has been forced to withdraw.[13]

There is also the very interesting question, which has not been litigated in the corporate area in any

13. *See* Lewis v. Shaffer Storage Co., 218 F. Supp. 238 (S.D.N.Y. 1963), discussed in Note, *Independent Representation for Corporate Defendants in Derivative Suits*, 74 Yale L.J. 524 (1965); Basch v. Talley Indus., Inc., 118 BNA Sec. Reg. L. Rep. A-22 (Sept. 15, 1971); Seifert v. Dumatic Indus., Inc., 197 A.2d 454 (Pa. 1964); Garlen v. Green Mansions, Inc., 193 N.Y.S.2d 116 (1959); Essential Enterprises Corp. v. Dorsey Corp., 182 A.2d 647 (Del. 1962); Murphy v. Washington Am. League Base Ball Club, 324 F.2d 394 (D.C. Cir. 1963); Marco v. Dulles, 169 F. Supp. 622 (S.D.N.Y. 1959). *See generally* Annot., *Representation of Conflicting Interests as Disqualifying Attorney from Acting in a Civil Case*, 31 A.L.R.3d 715; Opinion 642 of the Association of the Bar of the City of New York; ABA Formal Opinion No. 594; Tockman, *The Position of Corporate Counsel in Derivative Actions*, 51 Ill. B. J. 654 (1963); Elden, *Litigation under Illinois Securities Law*, 60 Ill. B. J. 28, 42-45 (1971); Code of Professional Responsibility, Canon 5, EC 5-16 and 5-18.

significant way, of whether or not counsel who enters an appearance for management in this kind of litigation is acting in a manner antagonistic to the corporation, which is his client, and whether thereby he is not acting against the interests of his client in a way to disqualify him from acting as corporate counsel in some future situations.

In that connection, let me read a series of comments in a recent case involving a union representation. The case is *Yablonski v. United Mine Workers of America*,[14] decided on July 21, 1971 by the United States Court of Appeals for the District of Columbia per curiam. It is interesting to note that Judge McGowan, whose remarks I read to you a few moments ago, was on the three-judge panel which heard that case.

In *Yablonski*, the regular counsel for the union had entered an appearance for both the union and for individual defendants, who were the officers of the union. The suit involved a dissident member of the union asking to recover from the officers on behalf of the union for alleged diversions of money. Counsel for the union then withdrew as counsel for the individual defendants, so that he would be no longer acting in a dual capacity. Motion was then made that he should not be permitted to act as counsel for the union because he had previously shown that his primary identification was with the interests of the individual defendants. The court stated:

> "[I]n the exploration and the determination of the truth or falsity of the charges brought by these individual appellants against the incumbent officers of the union and the union itself as a defendant, the UMWA needs the most objective counsel obtainable. Even if we assume the accuracy of the appellee's position at the present time that there is no visible conflict of interest, yet we cannot be sure that such will not arise in the future.
>
> "Whether facts are discovered and legal positions taken which would create such a conflict of

14. Yablonski v. United Mine Workers of America, 448 F.2d 1175 (D.C. Cir. 1971).

interest between the UMWA position and the position of the individual defendant Boyle may well be determined by the approach which counsel for the UMWA takes in this case."[15]

The court here is making a very sophisticated and realistic judgment that, in litigation or in the drafting of documents or the shaping of a deal, the manner in which the matter is tailored in the early stages may determine the way it comes out and the way it fits in the end. The court is perceptively indicating that the bias of counsel who is engaged in dual representation may shape the matter in a way that counsel might not even be aware of, to the detriment of the union and Yablonski, and also to the corporation in a comparable case.

The court goes on to draw the obvious analogy to the stockholders' derivative suit and says:

"Certainly no corporate counsel purports to represent the individual officers involved, neither in the particular derivative suit nor in other litigation by virtue of which counsel necessarily must create ties of loyalty and confidentiality to the individual officers, which might preclude counsel from the most effective representation of the corporation itself. The corporation has certain definite institutional interests to be protected, and the counsel charged with this responsibility should have ties on a personal basis with neither the dissident stockholders nor the incumbent office holders."[16]

IV. DUAL REPRESENTATION IN MERGERS

Turning to the *Amax* case,[17] the situation was fundamentally this: The subsidiary (RST) was a Zambian corporation; the parent, American Metal Climax, owned some 42% of its stock. The subsidiary's problems in complying with Zambian law and Zambian nationalization decrees presented the sub-

15. *Id.* at 1179.

16. *Id.* at 1181.

17. Kohn v. American Metal Climax, Inc., note 12, *supra*.

sidiary with some very difficult decisions. Eventually, after considering some alternatives, the subsidiary and the parent corporation decided to merge the subsidiary into the parent.

The negotiating team for the subsidiary consisted of directors who were dominated by the parent and who had close affiliations with the parent. The court stated that counsel for the parent and counsel for the subsidiary were the same. In the subsidiary's solicitation of proxies (which was undertaken without the necessity of complying with the federal proxy rules because the corporation was incorporated outside the United States), an explanatory statement was sent out to induce the outside stockholders of the subsidiary to approve the merger.

The lawsuit, brought under 10b-5, asserted material deficiencies in this proxy solicitation material. There were several alleged deficiencies which are complex and interesting; I haven't time to consider all of them in the context of our particular interests. One of them was the fact that there was no disclosure that the same counsel advised both the parent and the subsidiary. The court found that failure to make that disclosure was omission of a material fact and constituted a violation of Rule 10b-5.

The court stated that, "Sullivan & Cromwell thus placed itself in a clear position of conflict of interest. Though this position is sought to be justified because the RST directors agreed to allow Sullivan & Cromwell to continue to represent it notwithstanding the conflict, such agreement is meaningless in view of AMAX'S control of RST and the RST board. Nevertheless, even assuming that Sullivan & Cromwell could continue to represent both, their position is a material fact which should have been disclosed to the shareholders. It would be important for shareholders, in evaluating the advice of RST directors to vote in favor of the amalgamation, to know that through December 1969 RST was being advised by lawyers who were also advising AMAX."[18]

18. *Id.* at 1362.

This case is now pending on appeal. It has been argued, but no decision has yet been rendered. In the brief of Sullivan & Cromwell, on behalf of appellants, it is stated as follows: "When it appeared, however, in December of 1969, that Amax and RST were to negotiate externalization of Amax's assets on the basis that it would result in RST being treated differently from other RST shareholders, Sullivan & Cromwell promptly advised RST that it could no longer represent RST and recommended that other American counsel be obtained. At no time did Sullivan & Cromwell advise RST with respect to negotiations with Amax."[19] In fairness to Sullivan & Cromwell, I think that their withdrawal, which the lower court did not mention, ought to be known.

A. Timing of Withdrawal

The question of whether or not their withdrawal, after the questions of the subsidiary's mode of procedure were well under way but before the form of the transaction had crystallized, was a timely withdrawal is something about which we have very little learning. I may say that the only thing that I have found on that subject is Opinion 842 of the Association of the Bar of the City of New York which deals with dual representation in a derivative suit and says: "Wherever the facts are such as to make it improper for the same attorney to represent both classes of defendant throughout an action, it would be equally improper for the same attorney to represent the two classes of defendant even for a short period of time." I don't know how applicable that comment is, but at least it does shed some modicum of light on the question of the promptness of withdrawal.

B. The Possibility of Consent

If we alter the facts in the *Amax* case slightly, and assume that counsel for the parent and the subsidiary represented both parties in the merger negotiations, a different issue is presented. Could there be informed consent within the meaning of the Code of

19. Kohn v. American Metal Climax, Inc., note 12, *supra*, Brief for Appellants.

Professional Responsibility[20] which would be useful and which would enable the same counsel to represent both sides? Although the court did not face that precise question, it indicated that the board of directors of RST was dominated by Amax and, therefore, RST's consent was meaningless.

If there had been an independent majority on that board—(and I think the likelihood of having an independent majority on a board where you have a dominant parent of this kind is very, very remote—but, if there had been), could they have given consent? I submit that they could not. In a case where there is a clear, sharp conflict of interest, the Code and the language of the court indicate that the lawyer himself must take the responsibility of refusing to place himself in a position where his loyalties must necessarily be divided and his judgment impaired. Obviously, the same view would hold if consent were given by independent minority directors.

1. *Consent by Shareholders of Subsidiary*

Assuming that such dual representation is not permissible, is there anything else that counsel could have done in the actual *Amax* situation? Could counsel have got consent not from the board of directors of the subsidiary but from the minority shareholders of the subsidiary; and would that have been valid?

If my basic belief is correct that counsel could not in such circumstances really convince himself without some kind of unsuitable mesmerism that he would be able to act independently and properly on behalf of both sides, I would suspect that the approval by minority stockholders would simply not give a suitable certificate of chastity to the dual representation, assuming the consent could be obtained.[20a]

20. See Code of Professional Responsibility, EC 5-16; see *also* ABA Canon 6.

20a. For a different view, see remarks of Professor Folk, at pp. 196-204, *supra*.

2. *Disclosure to Shareholders*

If it were necessary to get such consent and if my reactions on this are unduly strict or are in error, then let us look at the situation from a practical point of view; when could this kind of notice be given? What would it have to contain and how should it be presented? The language of the Code of Professional Responsibility says that, before undertaking dual representation, counsel must be sure that his judgment is not impaired or his loyalty divided[21] and then, prior to acting, he must explain the circumstances to the clients and must obtain their consent.[22] The explanation which counsel must make is one that gives the client the opportunity to evaluate the client's need for representation free of any potential conflict and to explain fully to each client the implications of the dual representation.

If counsel had to send out notice to shareholders before accepting the dual representation and had to explain to shareholders (a) that his judgment may be affected, (b) what the sensitive points in the situation are on which independent counsel might be needed, and (c) the implications of not obtaining independent counsel, I think that, as a practical reality, such dual representation is not going to eventuate. I would agree that it may well be possible to obtain such consent in such a fashion in connection with the relationship between a mutual fund and an adviser to the mutual fund, where you often have a somewhat similar adversity of interest. That consent could be obtained in connection with the periodic approval of the contract between the fund and the adviser and the annual approval of the accountants.

3. *Consent by Unaffiliated Directors*

PROFESSOR MUNDHEIM: Stan, are you saying that you have to go to shareholders for approval? Why isn't approval by the unaffiliated or non-interested directors sufficient?

PROFESSOR KAPLAN: I don't think that the unaffiliated directors can speak for the corporation. I

21. EC 5-15.

22. EC 5-16.

am not at all sure, even if such consent were given in a situation where there is a directly adverse interest, that the present Code authorizes counsel to represent differing interests which leaves counsel in a situation where either his loyalty might be impaired or his judgment affected.

The statement of Ethical Considerations in the Code of Professional Responsibility (EC 5-15) puts on the lawyer the obligation to "weigh carefully the possibility that his judgment may be impaired or his loyalty divided" if he undertakes dual representation, where the interests may possibly be different. The lawyer is further required to resolve all doubts against the propriety of the representation.[23] Consequently, I do not think that a lawyer who is asked to represent both the parent and the subsidiary in a merger transaction, a situation in which there are significant possibilities of antagonistic interests, can reasonably come to the conclusion that his loyalty may not be divided or that his judgment may not be impaired in such dual representation. Therefore I do not believe that a lawyer is justified in undertaking such dual representation. According to the Code of Professional Responsibility (EC 5-16), it is only after the lawyer has made the determination that he is justified in representing two or more clients having differing interests that the question of obtaining the consent of both clients—after proper explanation—becomes relevant.[24] Consequently, I do not think that the matter of consent by an independent board of the subsidiary is meaningful because the question of such representation is ruled out at an earlier stage because of the differing interests, which I do not think can be reconciled.

This, of course, raises the obvious question of when, if ever, does the requirement of consent by clients in a dual representation come into play. Presumably, according to EC 5-15, it will come into play only if the interests of the multiple clients "vary only slightly," in which situation EC 5-15 says "it is generally likely that the lawyer will not be subjected to an adverse influence and that he can retain his independent judgment on behalf of each client; and

23. EC 5-15.

24. *See* ABA Canon 6.

if the interests become differing, withdrawal is less likely to have any disruptive effect upon the causes of his clients."

I do not believe the interests of the parent and the subsidiary in such a situation as *Amax*[25] could be said to involve a situation in which the interests of the respective clients varied only slightly.

I realize that this statement of ethical considerations sets a very high standard and imposes the burden of making a very serious decision squarely upon the lawyer. I also believe that this statement of professional responsibility probably bars the lawyer from representing multiple interests in many situations in which many lawyers have heretofore followed the practice of doing so.

Consequently in a situation such as *Amax*, the present Code is probably susceptible of the interpretation that consent may well be ineffective, from whomever it comes. Now, I may be reading the Code too strictly or harshly. But I would be very unsure if I were to take the opposite position.

If I am wrong in that, and if consent is effective, then it may be necessary to go to such portion of the corporation as is independent for such consent. And, I think that means independent in a practical sense.

4. *Consent by Minority Shareholders of Subsidiary*

If we look to the persons ultimately in interest, namely, the minority shareholders of the subsidiary, then it may very well be that their consent is all that is necessary. If so, then counsel faces a serious time element. There is also the basic question of whether or not the affirmative approval of minority shareholders is necessary which, I suspect, will be difficult to obtain, because I suspect that inertia will often prevent them from giving approval in this kind of circumstance. I suspect that counsel may have the problem of whether or not he can operate on a consent to a proposal that counsel will act as a dual representative unless there are a specified percentage of objections. Whether lack of objection is equivalent to consent is an arguable point; that question

25. Kohn v. American Metal Climax, Inc., note 12, *supra*.

was argued in connection with reorganizations all the way through the 1930's.

MR. FLEISCHER: I would think that, if you went to the unaffiliated directors and they gave their consent, such action should be adequate in the sense that the unaffiliated directors, in terms of responsibility under the Investment Company Act, make a variety of decisions that affect the relationships between the adviser and the fund which themselves are conflict situations.[26]

PROFESSOR KAPLAN: That may very well be true insofar as the relationship between the adviser and the fund is concerned, which is not, however, conclusive in connection with the relationship of the lawyer to his client. It may be that the Code of Professional Responsibility will be interpreted in accordance with your interpretation; or it may well mean that the Code will have to be clarified either by revision of its language or by an interpretation by the Ethics Committee of the Bar Association. If it remains in its present form, I think it leaves a very serious problem for counsel to grapple with.

C. Penalties for Representing Differing Interests

Now, if counsel represents clients in a differing-interest posture without obtaining appropriate consent or without being freed from the necessity of obtaining consent—in other words, if he directly violates the Code, as the judge in the *Amax* case[27] said occurred in that case—what is counsel really facing from the point of view of practical considerations?

I suppose that counsel, however distinguished, who violates the Code of Professional Responsibility, would face exactly the same kind of discipline as would counsel who violates prohibitions against ambulance chasing or any other prohibited activity; censure, suspension, and, in aggravated cases, disbarment or more severe penalties.

26. The ability of independent directors of a fund to consent to counsel's representation of both the fund and the investment adviser is discussed in Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179 (1971), and Mundheim & Nutt, *The Independent Directors of Mutual Funds*, WHARTON QUARTERLY (Spring 1972).

27. Note 12, *supra*.

I don't really see severe discipline as a very likely thing. But I do suggest that counsel who faces the prospect of being embarrassed will act with greater frequency and rapidity in introducing independent counsel. I also recognize, realistically, that counsel who replaces general counsel for both the parent and the subsidiary will never be as free as one might want where the subsidiary is negotiating with its parent and where the parent nominates the subsidiary board. First, counsel will usually be selected by the dominated board, although conceivably he could be selected by the independent members of the dominated board. Whether independent representation will result in any greater allocation of securities or any fairer deal for the minority shareholders is something that I would hesitate to predict. But I suggest that, if we believe in the adversary system of representation and if we believe that counsel should be as little subject to the restraint which comes from the duality of interest as can be arranged, then I would suspect that an opinion by one of the ethics committees of one of the major bar associations would have a very stringent effect upon the practice of representing both the parent and the partially owned subsidiary or both the mutual fund and its adviser.

The need for independent representation of the fund and its adviser at least in some situations of critical conflict, would seem to be required by the implications of *Rosenfeld v. Black*,[28] which makes clear the conflict between the interests of the fund and of its advisers in connection with the transfer of the management of the fund from one adviser to another.

V. REPRESENTATION OF SELLER OF A CONTROL BLOCK

A related problem occurs where counsel who represents the corporation is asked to represent the controlling shareholder who is selling his block of stock at a premium. I interpret *Perlman v. Feldmann*[29] and

28. 445 F.2d 1337 (2d Cir. 1971).

29. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

the later case of *Essex v. Yates*[30] as permitting a controlling shareholder to sell his controlling stock at a premium. I think the *Perlman* case imposes liability on the seller only because there has been a diversion of either goodwill or something analogous to a corporate expectancy or opportunity.[31] Let's assume that corporate counsel is consulted by the controlling stockholder with respect to the sale of his block of stock at a premium. Let's assume also that the controlling stockholder was first approached with a merger offer directed to the corporation which would have given all shareholders the same deal, but the controlling stockholder said, "I will not vote for a merger but I will be amenable to the sale of my block of stock at a price that I stipulate."

Could corporate counsel represent the controlling shareholder in such a situation where litigation between the corporation and the controlling shareholder may be lying implicit in the transaction? Similarly, can counsel for the corporation properly consult with a director with respect to the possibility of undertaking a transaction which may present the possibility of being considered a corporate opportunity, if diverted from the corporation to the director? I suggest that pretty much the same considerations that weighed in the *Amax* opinion apply to this kind of a situation. Who can give consent to such dual representation, and whether effective consent can be given in a situation of such sharp adversity of interest, is uncertain. I suggest that even if consent can be given, that counsel would be very well advised to avoid the question and to have independent counsel dealing with both sides of such problems.

VI. TENDER OFFERS

Another aspect of professional conduct about which I have been much troubled is to be found in

30. Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962).

31. A contrary reading of the Perlman v. Feldmann case can be found in Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505 (1965), and in Andrews & Sargeant, *Sale of Control: The Meaning of Perlman v. Feldmann Today* in PLI, First Annual Institute on Securities Regulation 138-58 (1970). However, the problem discussed in the text assumes that the Seller is improperly diverting a corporate opportunity.

the area of tender offers. My own early practice in the 1930's was largely in reorganization matters. At that time there was much comment about "strike suits," nuisance litigation, and "unprofessional conduct." In a tender offer situation there are many problems which I think ought to give the bar serious concern. For example, one of the frequent current gambits in the defense against the tender offer is the filing of litigation, frequently on an antitrust theory, by a target company against the party making the tender offer; those suits are often suspiciously suggestive of frivolous litigation for dilatory purposes.

A. Dilatory or Frivolous Litigation

In the recent suit by GAF Corp. against the Circle Floor Co.,[32] GAF's antitrust allegations against certain takeover aspirants were dismissed by the court in the Southern District of New York with the observation that the complaint was "a form of gamesmanship from which the processes of a busy court should not suffer."[33] In view of the foregoing, was counsel for GAF subject to criticism for bringing litigation that might very well be considered frivolous? A recent article on the subject of defense against a tender offer says: "From the viewpoint of the corporation defending against the tender offer, the principal purpose of litigation is delay."[34]

I wouldn't for a moment suggest that counsel does not have the right to bring any litigation which is proper and appropriate. But, I am not sure that the bringing of any litigation whatsoever merely for the purposes of delay is proper or appropriate. Are not such tactics and advice at least arguably vulnerable within the common law policy against fomenting litigation? Do such tactics constitute forbidden harassment through lawsuits, as proscribed by Disciplinary Rule 2-109 of the Code of Professional Responsibility?[35]

32. 112 BNA Sec. Reg. L. Rep. A-10 (July 28, 1971).

33. *Id.*

34. Herzel, *Strategy and Tactics in Stockholder Litigation*, 11 Corp. Prac. Commentator 364 (1970).

35. "The Disciplinary Rules, unlike the Ethical Considerations, are mandatory in character. The Disciplinary Rules state the minimum level of conduct below which no lawyer can fall without being subject to disciplinary action." Preliminary Statement to the Code of Professional Responsibility. *See also* DR 7-102(A) (1); ABA Canon 30.

I do not assert the affirmative to such questions without doubt or trepidation; I do submit, however, that a negative answer cannot with certainty be given. I suggest, therefore, that lawyers and bar associations must examine the role of counsel in such matters and should focus sharply on the questions of propriety, instead of assuming that anything goes in a fight. At the very least, the Marquis of Queensberry rules still apply. It may be significant that the only person quoted in the brochure setting forth the Code of Professional Responsibility is Abraham Lincoln, whose message primarily says that a lawyer should: "Discourage litigation.... Never stir up litigation."

B. Acquisition To Enable Litigation

I suspect that one might raise a similar question of improper conduct if counsel recommends to a client, for example, as I have seen press accounts suggest, that the client should buy a company so that, when a certain expected tender offer is made, the recommended purchase will precipitate a ground for the client's bringing of an antitrust litigation, thereby creating a synthetic situation designed to provide a basis for litigation. I'm not sure at all whether such a recommendation might not fall afoul of proscriptions against fomenting of litigation.

C. Perpetuation of Management

There is also another fundamental question in connection with defending against tender offers.

We have all seen newspaper reports—if not actual situations—describing drastic efforts to repel outside purchasers of control and to perpetuate current management through possibly selfdestructive methods, which have the potential of being highly injurious to the corporation imbibing such drastic medicine. For example, suppose management recommends a charter amendment requiring that an 80% stockholders' vote shall be necessary to authorize a merger, in a situation where management owns 21% of the corporation's stock. This gives the 21% shareholder group total veto power

over the future of the corporation and disables the corporation from agreeing, without the consent of the veto-holders, to favorable future mergers which, under customary voting arrangements, would be readily available to the corporation.[36] Or, take the situation that was reported in the press with respect to a Texas-based electronics company where the corporation's loan agreement was changed—allegedly at the instance of the borrower—to provide that the note automatically matured at the option of the lender if there was a change in control of the corporation. This places a corporation in the position of risking financial hara-kiri by making its own position precarious in the effort to deter a would-be acquirer. What responsibility does counsel have in the handling of such a situation? Do standards of professional responsibility restrict counsel from suggesting the possibility of this kind of tactics, which may protect the management but may injure the corporation? If so, who is counsel's real client and who is he really representing? Does counsel have an obligation to suggest or to insist upon notifying other shareholders of the possibilities inherent in this type of charter amendment or loan provision? Does he have the obligation to point out that this is so questionable a practice that he will not be associated with either the planning of it or its implementation?

I suggest there is a serious problem of professional responsibility in the handling of tender offers which we should all consider. The promotion of frivolous litigation should not be a permissible type of warfare. It does not accord with proper standards of professional conduct to foment rearrangements of corporate structures in a way that may impose serious restraints upon the corporation and inhibit its development. The protection of incumbent management is not a sufficient ground to warrant the use of such tactics.

36. See Wetzel, *Defensive Tactics—Who Are the Goodies and Who Are the Baddies?*, 25 Bus. Law. 545 (1970).

D. Defensive Tactics

In a number of recent articles on defensive tactics[37] against tenders, various authors have paraded a whole panoply of recommendations to make target corporations less vulnerable; in too few of these articles has question been raised with respect to the propriety of the conduct recommended or the suggestion of even the remotest possibility of any ethical considerations being involved. Since this area of tender offers is one in which the tactics are heavily influenced or affected by legal considerations and ramifications, the lawyer is often pretty much in command; a wider recognition of the application of standards of ethical propriety in defensive tactics and the development of some consensus on the part of the organized bar concerning the permissibility of various tactics could help a great deal in eliminating many questionable practices in connection with the defense against tender offers.

The Code of Professional Responsibility indicates that counsel for the corporation owes his duties directly to the corporation and not to the stockholders or to management or to any director.[38]

VII. COUNSEL'S DUTY TO THE CORPORATION

There is one interesting opinion, handed down in 1932 by the ABA Ethics Committee, which states that a general counsel for a corporation who is also a director and an officer of the corporation and stockholder could not act as a proxy in a proxy contest and could not support a particular slate of candidates.

37. On defensive tactics generally, see Bromberg, *Tender Offers: Safeguards and Restraints — An Interest Analysis*, 21 Case W. Res. L. Rev. 613, 618-19 (1970); Cary, *Corporate Devices Used to Insulate Management from Attack*, 25 Bus. Law. 839 (1970); Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. Pa. L. Rev. 317,360-70 (1967); Hays & Taussig, *Tactics of Cash Take-over Bids*, 45 Harv. Bus. Rev. 135 (March-April, 1967); Jacqua, *Defenses against Uninvited Tender and Exchange Offers*, 59 Ill. B.J. 106 (1970); Mullaney, *Guarding against Take-overs — Defensive Charter Provisions*, 25 Bus. Law. 115 (1967); Note, *Defensive Tactics Employed by Incumbent Management in Contesting Tender Offers*, 21 Stan. L. Rev. 1104 (1969).

38. EC 5-18.

It says: "In his acting as general counsel, he is acting as the corporation's attorney only and not as the attorney of any group of its stockholders, directors, officers or individuals or any group or faction. In acting as the corporation's legal adviser, he must refrain from taking part in any controversies or factional differences which may exist among stockholders as to its control." That language is almost tracked by Ethical Consideration 5-18.

I realize it would be very difficult for any ethics committee to police these very complex transactions and these very uncertain obligations. However, the NASD is doing almost the same task with respect to brokers, judges are similarly equipped to do it, and I think that possibly ethics committees might make a beginning. I think that lawyers have the obligation of focusing on such problems.

There has never really been much consideration of these problems either in the courts, in the literature, or in the opinions. The case books on professional responsibility are singularly lacking in adequate consideration of lawyer's conflict of interest.[39] I would like to leave you with the thought that there may be some very serious problems inherent in this series of situations for us as lawyers. We are acting in an area of nebulous uncertainty with the possibilities of grave criticisms to which lawyers should be responsive.

VIII. LIABILITY UNDER RULE 10b-5

I also would like to suggest one further thought. Accountants and directors have unhappily found that their standards are being policed by Rule 10b-5.[40] I am told that although counsel was not named as a defendant in 10b-5 actions until recently, that in some districts it is now becoming not un-

39. One recent article focuses specifically on the professional responsibilities of counsel in acquisitions. See Mundheim, *Representing the Acquired Company in Merger Negotiations: Some Problems of Professional Responsibility*, 10 Corp. Prac. COMMENTATOR 217 (1968).

40. *See, e.g.*, Lanza v. Drexel & Co., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,826 (S.D.N.Y. 1970); Heit v. Weitzen, 402 F.2d 909 (2d Cir 1968), *cert denied*, 393 U.S. 1074 (1969); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

heard of to name general counsel as an additional defendant.

I would really be somewhat uncertain whether counsel would be completely sure to be able to avoid personal liability in a situation where there was a serious deficiency in a document which subjected the directors to 10b-5 liability, where counsel was well aware of the whole set of facts and of the deficiency, and where counsel in addition had a conflict of interest which could be said to have influenced his position. I know of no case on this.[41] I hope I don't learn of any law on this.

I would, however, like you individually to consider how you could defend that kind of litigation and whether you feel that there might not be a possibility of liability in such a situation which might give us lawyers pause.

PROFESSOR MUNDHEIM: The Commission has also signalled its concern about the standards of professional responsibility and the conduct of the bar.

COMMISSIONER LOOMIS: That is true. We have been worried a little bit about this. First, I want to give you the background.

The practicing bar has an indispensable role in the administration of the securities laws. Without

41. Recent developments in this area include, SEC v. National Student Marketing Corp., Civ. No. 225-72 (D.D.C. 1972), where the SEC is seeking injunctive and other relief against two nationally prominent law firms who represented parties to a merger. The complaint charges, *inter alia*, that defendants "failed to refuse to issue their opinions [stating that all steps taken to consummate the merger had been validly taken], failed to insist that the financial statements be revised and shareholders be resolicited, and failing that, to cease representing their respective clients and, under the circumstances, notify the plaintiff Commission concerning the misleading nature of the nine month financial statements." A lawyer is among the multiple defendants in the connected cases of SEC v. Caldwell Indus., Inc., Civil No. 71-5415 (S.D.N.Y. 1971), and SEC v. Fields, Civil No 71-5416 (S.D.N.Y. 1971), discussed in 132 BNA Sec. Reg. L. Rep. A-8 (Dec. 22, 1971). *See also* Black & Co. v. Nova-Tech, Inc., 333 F. Supp. 468 (D. Ore. 1971), where the court held a lawyer was a participant in an illegal securities transaction because he prepared the legal papers necessary to complete the sale, although he did not know and could not have known of the illegal quality of the transaction. In addition, the court held the law firm was a participant in the sale because it authorized the company to include its name as corporate counsel on the 1968 and 1969 annual reports, which were used in promoting the allegedly illegal sales. The court did, however, indicate that lack of knowledge about the illegal transaction would be relevant at the subsequent proceeding concerning the issue of liability.

their participation and skill, I don't think the Acts would work. We are concerned and we are inclined to feel that counsel who causes a particular course of action to be pursued or who decides whether or not investors will receive disclosure and, if so, how and at what time, has some public responsibility to the investors and stockholders whose interests are also at stake. He needs to bear that in mind and not to think of himself as having no responsibility whatsoever to anyone other than corporate management.

This does not mean that we are going to second guess counsel who exercise a professional judgment in good faith. But, if we conclude on the basis of the facts of a particular case that there was not a good faith exercise of professional judgment, then there may be a problem.

This does not mean that we will be disturbed just because counsel reaches a result opposite to what we did. That is his privilege and prerogative. But, I'm talking about the good faith exercise of professional judgment. If he is not acting in good faith, if he is deliberately trying to help his client violate the law, we are going to be disturbed about it and we may well see what remedies are open to us.

A more difficult case on which we do not have any view established yet is the case where counsel was not deliberately acting in bad faith but where it is obvious that what counsel did was indefensible under the established interpretations of the securities laws. Counsel at least knows that the securities laws exist. We will be worried about that. Whether we will do anything remains to be seen.

PROFESSOR MUNDHEIM: I would like to underscore Phil's remarks by reminding you of the recent case of *SEC v. Century Investment Transfer Corp.*,[42] in which counsel was found to be an aider and abettor of a securities law violation because of misleading opinion letters which he gave.

IX. QUESTIONS

PROFESSOR KAPLAN: I have had a couple of questions in written form put to me which I would

42. SEC v. Century Inv. Transfer Corp., CCH Fed. Sec. L. Rep. ¶ 93,232 (S.D.N.Y. Nov. 17, 1971).

like to take this opportunity to answer. The first question is:

> "May not possible conflicts of interest in legal representation of an investment company and an adviser be reduced if the independent directors retain separate counsel from the counsel retained by the investment adviser and the investment company? If so, is it proper that the legal fees of separate counsel for the independent directors be paid by the investment adviser?"

The independent directors may well be benefitted by the fact that they have separate counsel. However, if the board of directors as a whole acts on the advice of counsel who represents both the adviser and the investment company, it would seem to me as if the problem is the same as that of the *Amax* case[43] and that counsel's conflict of interest remains in full force. If independent counsel for the independent directors holds the same opinion as counsel who is in a conflict of interest position, such fact may bolster the opinion of the counsel with dual representation. If independent counsel for the independent directors disagrees with the counsel who represents dual interests, I would think that such fact would be seriously embarrassing. I think that the better course would be to have independent counsel represent the investment company rather than merely representing its independent directors.

If separate counsel for the independent directors is paid by the investment adviser, I think that such fact might raise the question of the independence of such counsel. Since counsel's fees are being paid by a person who is in effect the opposing party in interest, this represents a potential kind of pressure to which counsel should not be subjected and the appearance of which should be avoided.[44] I think that it would be more appropriate to have counsel for the independent directors paid by the investment company; I have no doubt that that would be a legitimate expenditure of funds by the investment company. I am not sure, however, that, if the independent directors hired separate counsel and if the

43. Kohn v. American Metal Climax, Inc., note 12, *supra*.

44. Code of Professional Responsibility, Canon 9, EC 9-6.

investment company refused to pay such counsel, either the independent directors or counsel would have the right to sue and obtain payment of counsel fees for such separate counsel.

The second question that has been put to me is as follows:

> "A and B are about to merge. Counsel for A is of the opinion that counsel for B is not adequate to the task. Consequently, counsel for A takes the primary role in drafting documents which under normal circumstances would be taken care of by counsel for B.
>
> "*Query* (*a*): Is counsel for A representing both A and B?"

Answer: If counsel is drafting documents which deal with more than ministerial matters and if he is undertaking the role of making decisions which have significant effect upon B and if he purports to be protecting B's interests, then I think he has undertaken the representation of B even though he may not formally have been appointed by B to do so and even though he is not being paid by B. Even if he is undertaking this role solely by arrangement with B's attorney and without B's knowledge, he has still, I think, put himself in the position of representing B. In this connection you might look at the language on somewhat similar subject in *E. F. Hutton Company v. Brown.*[45]

> "*Query* (*b*): Must counsel for A withdraw unless B gets new counsel?"

Answer: I am not certain that I understand the full implication of this question but, if it raises merely the point of whether counsel for A may represent A without undertaking the role of also acting as a guardian for B, I think that he may. I don't think that A's counsel needs to withdraw merely because opposing counsel is not competent. Whether A's counsel should apprise A, his own client, or B, the opposing party, of the situation presents other questions. I don't think it is permissible for A's counsel to advise B, the opposing party, of his counsel's inadequacies. Whether A's counsel can advise A of

45. 305 F. Supp. 371 (S.D. Tex. 1969).

this fact or whether A can advise B raises questions which I find difficult to answer with certainty.

"*Query (c):* Can counsel for A charge more due to his extra efforts when he knows that B, the surviving corporation in the merger, will actually pay the bill?"

Answer: Since I think it is a dangerous business for counsel to undertake this dual representation, either openly or surreptitiously, I have doubts about his being compensated for work he should not have undertaken. The fact that he charges A for work done for B, knowing that B is going to absorb A, doesn't seem to me to make the dual representation any more permissible.

"*Query (d):* What, if any, would be the liability to shareholders of B by counsel for A?"

Answer: This question assumes, I think, the charge by B's shareholders that A's counsel misrepresented them or failed adequately to guard their interests. Assuming that some action is taken or omitted by counsel for A to the detriment of B, can A's counsel be held personally liable for this malpractice? Assume further that this action or omission is one which would have given grounds for a malpractice action by B against B's own counsel, apart from the conflict of interest situation.

I think that counsel who is guilty of malpractice in not properly representing his client would be at least as likely to be held liable where he had a conflict of interest as where such a conflict of interest did not exist, and perhaps more likely. I have not done any research on the point, and I know of no cases on this subject. I think that there would be a very dangerous possibility of liability here and that the conflict of interest posture might put the counsel who is sued in the position almost of an errant fiduciary to the shareholders of B; he might very well be exposed to liability. I think the position is dangerous and that counsel should be very careful to avoid it.

Incidentally, it should be noted that it is not only in merger situations where counsel for one side is called upon to assist in representing his opponent. It happens quite frequently in connection with the drafting of registration statements, where counsel for the underwriter is a highly sophisticated finan-

cial lawyer, and particularly in the representation of companies going public for the first time, where counsel for the issuer is not experienced in the financial field. I think in all these situations the temptation to take over the functions of counsel for the other side can lead only to embarrassment, rancor, and, possibly, liability.