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# SISTER ACT: CONFLICTS OF INTEREST WITH SISTER CORPORATIONS

*Ronald D. Rotunda\**

## I. INTRODUCTION

The last two decades have witnessed an increasing number of mergers, spin-offs, purchases and sales of corporations and parts of corporations. All this activity has resulted in corporate families with ever-changing members. The corporate subsidiary of one corporation on any given day may be a member of a different corporate family on the next day. To this complex mixture we must add another ingredient: law firms themselves are increasing subject to mergers. The newly created firm may find that it is now representing a corporate client in one matter that is adverse to the interests of another corporation, and, while that other corporation is not a client, it is the parent, or subsidiary, or sister corporation of a client.

Under the law of corporations, each of the incorporeal beings of a corporate family are typically treated as separate entities — unless the corporate veil is pierced. However, under the law of ethics and attorney conflict of interests, courts are often assuming that piercing the corporate veil is the rule and not the exception. Attorneys have increasingly found themselves charged with unintended conflicts of interest when the law firm represents a client that becomes a member of a different corporate family.

Should separate corporations that are affiliated with each other be treated the same when a court is deciding whether to disqualify a law firm? Or should courts treat the corporate veil as something that is not easily pierced?

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\* The Albert E. Jenner, Jr. Professor of Law, University of Illinois College of Law. I am grateful to Robert E. O'Malley, Esq. for bringing various unreported cases to my attention and for my discussions with him on this issue. I am also indebted to William Freivogel for his thoughtful comments. Needless to say, I remain responsible for my conclusions as well as any errors in this paper. I also wish to thank Lawrence J. Fox. While we disagree about these issues, my dialogues with him have helped to sharpen my arguments.

Consider, first, a simple case. Assume that a lawyer (let us call her "Lawyer") represents a client called Corporation Alpha. This Lawyer has never represented another corporation, called Corporation Beta. May Lawyer represent Corporation Alpha, in the case of *Alpha v. Defendant*, while simultaneously representing another client suing Corporation Beta in a completely unrelated case, the case of *Plaintiff v. Beta*? Given these facts, the normal rules of ethics would find no conflict. The answer is, in fact, obvious. The Lawyer would be violating no ethics rules, would not be subject to discipline, and the judge in either the *Alpha* case or the *Beta* case would find no reason to disqualify the lawyer.

Now, we shall add one more fact: Corporation Beta is the parent, or subsidiary of Corporation Alpha. Or, Beta and Alpha are sister corporations — that is, they are separate corporate entities each owned by a third corporation. The question, more precisely restated, is whether a lawyer may represent a corporation in one matter while undertaking representation adverse to an affiliate of that corporation in a different, unrelated matter. The cases or representations still have no relation to each other; that is, there is no confidential information that the Law Firm learned from Corporation Alpha that would be relevant in representing Plaintiff in the case of *Plaintiff v. Beta*. The Law Firm does not acquire, by its representation of Corporation Alpha, any improper advantage in representing Plaintiff against Corporation Beta. If, in fact, Corporation Alpha were not affiliated with Corporation Beta, there would be no conflict of interest.

All of these references to Greek letters may remind lawyers too much of high school Algebra, so permit me to substitute a more concrete example. Assume that a law firm does some title work for Taco Bell, as it opens a few more restaurants. The same firm also decides to represent plaintiff, who is suing Kentucky Fried Chicken, because a KFC delivery truck ran into the plaintiff's car. Taco Bell and KFC are each separate corporations, so normally, there would be no ethical question involved. However, both are owned by Pepsico. Does that fact create a *per se* conflict of interests for the lawyer?<sup>1</sup> Should large parent corporations

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1. While corporations are members of the same corporate family, they treat themselves (and corporate law treats them) as separate entities. For example, Pizza Hut and Taco Bell decided to withdraw from advertising the Dana Carvey television show, because some of Carvey's humor was thought to be offensive. However, Pepsi-Cola is staying on as a sponsor. "We're all autonomous divisions that make independent decisions," said Pepsi spokesman Jon Harris. *Taco Bell Pulls Ads From Dana Carvey Show* (AP), CHAMPAIGN-URBANA NEWS-GAZETTE, March 15, 1996, at C1, col. 2.

Sometimes corporations are part of the same corporate family, even though they both are listed in the stock exchange. The stock market treats the corporations (e.g. General Motors and Electronic

that create separately-incorporated subsidiaries be able to treat themselves as separate corporations when it suits their purposes while still being able to treat themselves as a single entity for strategic purposes, that is, for purposes of disqualifying opposing counsel?

We should assume that the law firm, while representing Taco Bell, acquired no confidential information that would be at all relevant in the tort action involving the KFC truck. Given the facts of this case, that assumption is certainly a reasonable one to make. Let us also assume that Taco Bell, KFC, and Pepsico are run as separate corporations, and that it cannot be said that one corporation is the alter ego of any of the others.

KFC and Taco Bell both are wholly owned subsidiaries of Pepsico. To some commentators, it is of great moment whether the subsidiaries are wholly owned or only partially owned.<sup>2</sup> To these people, it appears that there would be a per se conflict of interest if the parent wholly owns the two subsidiaries but no such conflict if the parent owned 99 and 44 one-hundredth percent of the two subsidiaries. I find such a distinction unusually formalistic, reminiscent of nineteenth century jurisprudence<sup>3</sup> to conclude that the existence of a per se conflict automatically disappears if the parent owns some small fraction less than 100% of the subsidiary. I will argue that there is no per se conflict even if two subsidiaries are wholly owned by a third corporation. But, in those specific cases where courts should find a conflict,<sup>4</sup> if, in short, there is a conflict, it does not disappear simply because the parent has sold a small fraction of one of its subsidiaries to a third party.

Perhaps someone might think that the law firm representing a plaintiff against KFC might pull its punches in that lawsuit (in the hope of currying favor with Pepsico and thereby secure more business), so we should also assume that the law firm tells the tort plaintiff of its relation-

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Data Systems Corp.) as different entities. When General Motors decided to spin-off its Electronic Data Systems Corp. unit, there were significant negotiations between the two companies as to the amount of a one-time dividend from EDS to GM. The stock market, as well as EDS and GM treated the two corporations as separate entities. Gabriella Stern & Neal Templin, *GM, EDS Unit Are in Accord About Payout*, WALL ST. JRL., Oct. 9, 1995, at A3, col. 3. The market even awarded GM and EDS different *p/e* ratios.

2. See, Lawrence J. Fox, dissenting, in ABA Formal Opinion 95-390 (Jan. 25, 1995): "But here we are talking about a *wholly owned* corporate family." (emphasis added).

3. See generally, JOHN NOONAN, *PERSONS AND MASKS OF THE LAW* 4 (1976). Justice Holmes often attacked the practitioners of formalistic jurisprudence. E.g., SHELDON M. NOVICK, *HONORABLE JUSTICE: THE LIFE OF OLIVER WENDELL HOLMES* (1989); LIVA BAKER, *THE JUSTICE FROM BEASON HILL: THE LIFE AND TIMES OF OLIVER WENDELL HOLMES* (1991).

4. See notes 75 to 86, *infra*.

ship with Taco Bell and also advises the tort plaintiff that it believes<sup>5</sup> that it will vigorously sue KFC notwithstanding the fact that KFC is a sister corporation of Taco Bell. The tort plaintiff, after learning these facts, consents to his continued representation by the law firm. In other words, he decides to stay with the law firm, does not hire another lawyer, authorizes the law suit, and waives any right that he may have to object to any alleged conflict involving his lawyer. But what about KFC? Must the law firm also secure consent from KFC, its adversary in the litigation? Does KFC have the right to object to plaintiff hiring a law firm that does work for Taco Bell, if both Taco Bell and KFC are owned by Pepsico? Does Pepsico also have a right to insist on the disqualification of the law firm?

My hypothetical case is just that: hypothetical. I have in mind no specific case involving Pepsico. But the fact pattern I have described is hardly hypothetical. It happens every day, has spawned a great deal of conflicts of interest litigation, and sometimes results in the disqualification of the law firm.<sup>6</sup>

Consider *Stratagem Development Corp. v. Heron International N.V.*,<sup>7</sup> a federal court decision that answered the question that I have posed. *Stratagem* found a *per se* conflict. It ruled that, under New York law, a lawyer cannot sue its present client, and therefore cannot sue a subsidiary or affiliate of its present client. The court broadly announced that the duty with regard to suing a present client “applies with equal force where the client is a subsidiary of the entity to be sued.”<sup>8</sup>

In *Stratagem*, the law firm represented the plaintiff, who claimed an alleged breach of a joint venture agreement to develop certain properties. During this same period the law firm also represented a wholly-owned subsidiary of the defendant (“FSC”) involving an unrelated lawsuit. The court found that FSC was a present client of the law firm when it was investigating and drafting the complaint against FSC’s parent company.<sup>9</sup> Therefore, the court disqualified the law firm by using a test that was sweepingly broad in its implication: a lawyer cannot take a case adverse to the interests of a corporation affiliated with a law firm’s client because the “liabilities of a subsidiary corporation *affect the bottom line* of the

5. Its belief must be reasonable and in good faith. ABA Model Rule 1.7(b)(1). If the law firm were representing a tort plaintiff suing KFC, a present client, the conflict would be governed by ABA Model Rule 1.7(a), and the lawyer would have to secure the consent of each of its present clients, the tort plaintiff and KFC. See, Rule 1.7(a)(2).

6. See footnotes 10 & 13, *infra*.

7. 756 F. Supp. 789 (S.D.N.Y. 1991),

8. 756 F. Supp. at 792.

9. 756 F. Supp. at 793.

corporate parent.”<sup>10</sup> Nor can the law firm avoid the problem by dropping the disfavored client: the law firm “may not undertake to represent two potentially adverse clients and then, when the potential conflict becomes actuality, pick and chose between them.”<sup>11</sup>

At first glance, the fact situation posed in *Stratagem* may appear to be unusually narrow, arcane, or esoteric. Indeed, one must understand several other important rules of ethics before even approaching the *Stratagem* issue.<sup>12</sup> Yet the practical consequences of the *Stratagem* rule are far from obscure. Nor is *Stratagem* alone in the case law. A significant number of cases appear to adopt the principle that a law firm may not represent a party adverse to a corporate affiliate of a client, without consent of *all* parties, even though the matters are completely unrelated, even though one of the parties is the adverse party in litigation (who is therefore unlikely to give consent), and even though the court may also require consent by the corporate parent, which is not even a party to the litigation.<sup>13</sup>

10. 756 F. Supp. at 792 (emphasis added).

11. 756 F. Supp. at 794.

12. See § II, *infra*.

13. *E.g.* Gould, Inc. v. Mitsui Mining & Smelting Co., 738 F.Supp. 1121 (N.D. Ohio 1990); Telesat Cablevision, Inc. v. Opryland USA, Inc., No. 90-137-CIV-ORL-19, 190 WestLaw 303150 (M.D. Fla., July 25, 1990) (unreported); Cincinnati Bell, Inc. v. Anixter Bros. Inc., No. C-1-93-0871 (S.D. Ohio June 27, 1994) (unreported) (trial judge, in an unusually broad ruling, disqualified a law firm because he concluded that litigation against Anixter could affect the financial well-being of Anixter's parent, Itel, and therefore could indirectly affect the financial bottom line of the parent; the law firm was disqualified because it also represented a subsidiary of Itel in unrelated transactional work.).

Other cases that reject a rigid approach include the oft-cited, *Pennwalt v. Plough*, 85 F.R.D. 264 (D.Del. 1980), discussed below. This case emphasized that the legal departments of the affiliated corporations were not integrated and the law firm found itself in the situation when one corporation acquired another. The alleged conflict was “thrust upon” the law firm. See also, *e.g.*, *G.F. Industries, Inc. v. American Brands, Inc.*, 245 N.J.Super. 8, 583 A.2d 765 (1990), where the court concluded that the parent and subsidiary were separate entities for conflicts purposes; *In re. Wingspread Corp.*, 152 Bankruptcy 861, 1993 Bankr. LEXIS 553, Bankr.L.Rep.(CCH) ¶ 75,213, 28 Collier Bank. Cas.2d (MB) 1050 (Bank.Ct. S.D.N.Y. 1993); *Teradyne, Inc. v. Hewlett-Packard Co.*, 20 U.S.P.Q.2d (BNA) 1143, 1991 WestLaw 239940, U.S. Dist. LEXIS 8363 (N.D.Cal. June 6, 1991); *Apex Oil Co. v. Wickland Oil Co.*, 1995 U.S. Dist. LEXIS 6398 (E.D.Cal. 1995), holding that a parent and subsidiary corporation would be treated as the same entity for conflicts of interest purposes *only if* the two entities were, in fact, true alter egos.

*Cf.* *Whiting Corp. v. White Machinery Corp.*, 567 F.2d 713 (7th Cir. 1977), where the lawyer represented Plaintiff in a case against Defendant, while also representing, on unrelated matters, Corporation (which owns 20% of Defendant and had the power to appoint 40% of the Board of Directors). Plaintiff consented, but Corporation and Defendant did not; however, the lawyer agreed not to represent Corporation during the pendency of the case. The trial court refused to disqualify the lawyer and the Court of Appeals found no abuse of discretion. In *City Council v. Sakai*, 58 Hawaii 390, 570 P.2d 565 (1977), the court ruled that a lawyer may represent the city on bond matters while simultaneously suing the city (on behalf of a client) on unrelated matters. See also,

The *Stratagem* test — whether the “liabilities of a subsidiary corporation affect the bottom line of the corporate parent” — has enormous implications. A law firm could have trouble suing a corporation (such as General Motors) if any one of the law firm’s clients owned any stock in General Motors, because the liabilities (and even the potential liabilities) of General Motors “affect the bottom line” of GM.

If a law firm represents clients who used electricity or water (*i.e.* any client), then it could not also represent an electrical or water utility in the same geographic area urging a rate increase, because an increase in electrical or water rates will adversely “affect the bottom line” of the other clients. Indeed, *Stratagem* argued that if a law firm represented a trade association, it could not represent any other client in an unrelated law suit brought against any member of the trade association.<sup>14</sup> Should it be the law that if a law firm represents the American Bar Association, it can never represent a client injured in a car driven by a member of the ABA? And if that is the rule, what interests does it protect, and what do those interests have to do with ethics?

In order to analyze the Sister Corporation issue, we must first lay some preliminary groundwork and briefly look at the basic ethical rules that are not in dispute. Then, with this foundation in place, we will apply those rules to analyze an issue that is very much in dispute as we take a closer look at the question involved in the *Stratagem* decision and others like it.

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Hartford Accident and Indemnity Co. v. RJR Nabisco, Inc., 721 F.Supp. 534 (S.D.N.Y. 1989); The Vanderveer Group, Inc. v. Petruny, No. Civ. A-93-3677, 1993 WestLaw 398720, 1993 U.S. Dist. LEXIS 13614 (E.D.Pa. Aug. 13, 1993).

14. 756 F. Supp. at 792, citing *Glueck v. Jonathan Logan, Inc.*, 512 F. Supp. 223, 227 (S.D.N.Y.), *aff'd* on different grounds, 653 F.2d 746 (2d Cir. 1981). See note 32, *infra*.

To be distinguished is the case where disqualification is necessary to protect confidential information. Thus, when the law firm for the trade association *promised* its individual members that it would treat information from them as protected by the attorney client privilege, and then — on the strength of that promise — did obtain that confidential information, which was material to a substantially related case that the law firm then brought against several members of the trade association, the law firm should be disqualified in order to protect confidences. *Westinghouse Electric Co. v. Kerr-McGee Corp.*, 580 F.2d 1311, 1319-21 (7th Cir. 1978), *cert denied*, 439 U.S. 955 (1978). The Seventh Circuit court said: “Gulf, Kerr-McGee and Getty each entertained a reasonable belief that it was submitting *confidential information* regarding its involvement in the uranium industry to a law firm which had solicited the information upon a representation that the firm was acting in the *undivided* interest of each company.” 580 F.2d at 1321 (emphasis added).

## II. THE ETHICAL BACKGROUND TO THE SISTER CORPORATION ISSUE

### A. *Simultaneous Representation*

To place the Sister Corporation in proper perspective, we should first consider the disqualification rules governing simultaneous representation of adverse interests. Consider the situation where a law firm ("Law Firm") represents a corporation (let us say Corporation A) in various matters involving a particular issue, for example, labor law advice. Other members of the Law Firm represent other clients (let us say Corporations X, Y, and Z) on matters that have no relation<sup>15</sup> to the labor law matters; for example, the Law Firm may represent Corporations X, Y, and Z in connection with a patent infringement lawsuit that Corporation A has filed against Corporations X, Y, and Z.

A basic ethics rule is that Law Firm may not represent Corporations X, Y, and Z in this patent law suit against the interests of Corporation A, even though Corporation A is represented by its own counsel (who is separate from Law Firm) and even though the two representations have no relation to each other. In other words, a lawyer may not sue a present client during the course of a representation. The cause of the conflict is *not* a breach of the duty of confidentiality (for there are no relevant confidences to violate) but rather a breach of the duty of loyalty to a present client.<sup>16</sup>

Several policy reasons support this rule of loyalty. For example, Corporations X, Y, and Z, which are also clients of the Law Firm, may be concerned that the Law Firm, in suing Corporation A, might pull some punches in the dispute against Corporation A, because it anticipates (or hopes for) further business from Corporation A, its present client.

If that were the only reason, Corporations X, Y, and Z could eliminate the conflict by waiving it. However, their waiver is not sufficient because Corporation A also is hurt. The Law Firm is an agent of its principal, Corporation A. As such, the law of agency requires the agent

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15. The cases or representations have no relation to each other in the sense that there is no confidential information that the Law Firm learned from Corporation A that would be relevant in representing Corporations X, Y, or Z adversely to Corporation A. In other words, Law Firm (because it is simultaneously representing Corporation A) gains no improper advantage in representing Corporations X, Y, or Z.

16. See, e.g., *IBM v. Levin*, 579 F.2d 271 (3d Cir. 1978); *City of Little Rock v. Cash*, 277 Ark. 494, 644 S.W.2d 229 (1982); *Grievance Committee v. Rottner*, 152 Conn. 59, 203 A.2d 82 (1964). See generally, Robert C. Hacker & Ronald D. Rotunda, *Standing, Waiver, Laches, and Appealability in Attorney Disqualification Cases*, 3 CORPORATION LAW REVIEW 82 (1980).



to be loyal to the principal.<sup>17</sup> To sue a present client violates this duty of loyalty. Thus, the leading case of *Cinema 5, Ltd. v. Cinerama, Inc.*<sup>18</sup> said that the "lawyer's duty to his client is that of fiduciary or trustee," and that the client is "entitled to feel that at least until that litigation was at an end, it had his undivided loyalty as its advocate and champion." Each client is owed "the same fiduciary duty of undivided loyalty and allegiance."<sup>19</sup>

### B. Subsequent Representation

The duty to refrain from taking a case adverse to Corporation A only applies while Corporation A is a client of the law firm. There is no general rule prohibiting a client from suing a *former* client. Otherwise, any corporation, particularly a large one such as General Electric or General Motors, would be able to preclude many lawyers from ever taking positions adverse to them just because, years before, someone in the law firm had earlier represented them. There is, in short, no duty of loyalty to a *former* client.

However, clients are entitled to have lawyers forever hold in confidence "information relating to the representation."<sup>20</sup> That is why, subject to various exceptions,<sup>21</sup> the "duty of confidentiality continues after the client-lawyer relationship has terminated."<sup>22</sup> Thus, a law firm cannot take a case adverse to a former client if it retains any relevant confidential information from the former client, because the law firm may not

17. American Law Institute, Restatement of the Law Government Lawyers, Third, § 209, comment *e* (Tent. Draft No. 4, April 10, 1991).

18. 528 F.2d 1384 (2d Cir. 1976).

19. 528 F.2d at 1396. So strong is this policy, that courts have often said that this type of conflict — suing a present client — is not waivable. See, e.g., *Matter of Kelly v. Greason*, 23 N.Y.2d 368, 374-79, 296 N.Y.S.2d 937, 942-46, 244 N.E.2d 456, 459-62 (1969). The rule is an old one. See, ABA Formal Opinion 112 (May 10, 1034). *But see*, Comment 8 to ABA Model Rule 1.7, which disagrees:

However, there are circumstances in which a lawyer may act as advocate against a client.

For example, a lawyer representing an enterprise with diverse operations may accept employment as an advocate against the enterprise in an unrelated matter if doing so will not adversely affect the lawyer's relationship with the enterprise or conduct of the suit *and if both clients consent* upon consultation. . . . The propriety of concurrent representation can depend on the nature of the litigation. For example, a suit charging fraud entails conflict to a degree not involved in a suit for declaratory judgment concerning statutory interpretation. (Emphasis added).

20. ABA Model Rule 1.6 Comment 4. The ABA has not officially numbered the Comments to the Model Rules, although some courts, in adopting the Model Rules, have done so. The numbering system here follows that used in, THOMAS D. MORGAN & RONALD D. ROTUNDA, 1995 SELECTED STANDARDS ON PROFESSIONAL RESPONSIBILITY (Foundation Press, 1996).

21. See ABA Model Rule 1.6(a), (b).

22. ABA Model Rule 1.6 Comment 21.

ever reveal such information or use such information (even if it does not reveal it) about the former client.<sup>23</sup>

### C. The "Hot Potato" Doctrine

Lawyers are trained in the art of examining alternatives, of finding loopholes. Accordingly, we should not be surprised that some lawyers, who find it financially rewarding to take on a case against a present client, would seek to avoid the ethical problem by the simple expedient of making the present client a former client. Needless to say, the ethics rules have responded to this ploy by what is called the "hot potato" doctrine.

In *Cinema 5, Ltd. v. Cinerama, Inc.*,<sup>24</sup> in the course of disqualifying a law firm involved in a simultaneous representation of conflicting interests, the court cryptically noted, at the end of its opinion, that "the record shows that after learning of the conflict which had developed, the [law firm] offered to withdraw its representation of Cinerama in the [other case]."<sup>25</sup> The law firm, in short, tried to "fire" the client, thus converting the present client to a former one. Cinerama did not accept the law firm's efforts to go away, and so the law firm "continued, albeit reluctantly, to have one foot in each camp."<sup>26</sup> The court, without further comment, appeared to accept the right of the client to refuse to accept the law firm's efforts to withdraw from further representation of the client complaining about the conflict. Thus the law firm had its foot stuck in each camp, and the court therefore required the law firm to be disqualified in the case where the law firm was acting adversely to the client.

The *Cinema 5* court did not bother to explain its reasoning, but its conclusion is correct. The principle flows from the law of agency. The lawyer is the agent of the client, and therefore is a fiduciary. A fiduciary should not be able to profit from its breach of the fiduciary obligation of loyalty. Subsequent cases have ruled, in general, that a law firm may not drop a client like a "hot potato" simply in order to take on another, more favored client.<sup>27</sup> If a law firm has created a conflict, it will not be

23. ABA Model Rule 1.9.

24. 528 F.2d 1384 (2d Cir. 1976).

25. 528 F.2d at 1387.

26. 528 F.2d at 1387.

27. For cases discussing the permutations and limitations of the hot potato doctrine, see, e.g., *Pennwalt Corp. v. Plough, Inc.*, 85 F.R.D. 264 (D.Del. 1980); *Picker International, Inc. v. Varian Associates, Inc.*, 670 F.Supp. 1363 (N.D. Ohio 1987), *affirmed*, 869 F.2d 578 (Fed. Cir. 1989); *Gould Inc. v. Mitsui Mining & Smelting Co.*, 738 F.Supp. 1121 (N.D. Ohio 1990). See generally, *Rotunda, One Potato, Two Potato, Three Potato, Four*, 16 LEGAL TIMES OF WASHINGTON, D.C. (Aug. 12, 1991) at 23-24.

allowed to automatically shift resolution of a conflicts issue from ABA Model Rule 1.7 (dealing with current clients) to the more lenient standard of ABA Model Rule 1.9 (dealing with former clients) by the simple expedient of dropping one client in order to take on a more favored one.<sup>28</sup>

*Stratagem* understood the hot potato doctrine. It specifically stated that a law firm "may not undertake to represent two potentially adverse clients and then, when the potential conflict becomes an actuality, pick and choose between them."<sup>29</sup> However, the issue is not the hot potato doctrine; rather, it is whether it should properly apply to the facts of *Stratagem*. If the affiliated corporation is not a client, there would be no hot potato to drop.

#### D. Imputation

The operation of the rules dealing with disqualification of counsel are magnified by the fact that the disqualifications imposed by ABA Model Rule 1.7 (dealing with simultaneous representation) and Model Rule 1.9 (dealing with subsequent representation) are automatically imputed to all the other lawyers associated with a law firm.<sup>30</sup> A modern law firm may number many hundreds of lawyers, located in various cities stretching across the United States, or across the world. Each of these lawyers, like Typhoid Mary, can infect the entire law firm with their disqualifications.

Although the client may waive the benefits of this imputation rule,<sup>31</sup> it is often strategically advantageous not to do so. A party who can disqualify the other party's attorney imposes additional costs on the adversary, who must pay to reeducate a new lawyer. While the ethics rules look with disdain on conflicts raised for strategic purposes,<sup>32</sup> the fact remains that the implications of such stratagems are hard to ignore.

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28. E.g., Opinion RI-139 of the State Bar of Michigan Standing Committee on Professional and Judicial Ethics; *Ex Parte AmSouth Bank*, 589 So.2d 715, 721-22 (Ala. 1991) (law firm should not "benefit from a conflict that it has created," but the firm should not be disqualified if it "did not by its own actions create the conflict of interests.").

29. 756 F. Supp. at 794.

30. ABA Model Rule 1.10(a).

31. ABA Model Rule 1.10(c).

32. ABA Model Rule 1.7, Comment 15. Accord, Model Rule 1.9, Comment 14. See also, *Corp. v. Plough, Inc.*, 85 F.R.D. 264 (D.Del. 1980). In ruling against Plough, the court found "troubling" (85 F.R.D. at 274) Scholl's refusal to let the law firm withdraw in the antitrust case, in light of its request that the court in that case delay its ruling. It would be improper, said the court, to convert a reasonable effort to enforce the Canons into a "litigation tactic." 85 F.R.D. at 274. Yet such tactics are hardly foreign to modern day litigation. See Robert Hacker & Ronald D. Rotunda,

*E. The Lack of Appealability of Conflicts Motions and the Death of Precedent*

Since 1981, in *Firestone Tire & Rubber Co. v. Risjord*,<sup>33</sup> the Supreme Court has held that denials of motions to disqualify are not appealable as final decisions in civil cases. Subsequent courts have expanded that ruling so that neither the grant nor the denial of a motion to disqualify are now appealable as of right in either civil or criminal cases.<sup>34</sup> Many state courts have followed the federal lead and also reject the notion of a right to appeal on this issue. The parties are left with the cumbersome and procedurally difficult remedy of filing an extraordinary writ of mandamus.<sup>35</sup>

The consequence of the dearth a appellate court rulings since *Risjord* has led to what might be called the death of precedent in attorney disqualification cases. In the pre-*Risjord* era, there were many disqualification motions, and lower courts found themselves reversed with some regularity. A body of law was developing, and — because the Courts of Appeal were developing it — there were various bright lines and clear tests emerging to guide the lower courts in disqualification motions. A lower court that made up its own rules would be promptly reversed. In the post-*Risjord* era, trial court judges have almost *carte blanche* to disqualify, or not to disqualify as they see fit. While the U.S. Supreme Court is properly concerned about a conflict among the circuits, and will typically grant review to resolve such a conflict, a conflict among the district courts in attorney disqualification cases is now standard operating procedure. *Risjord* and the cases in its wake have not reduced the number of disqualification motions, but they have reduced the uniformity in the case law by preventing appeals.<sup>36</sup>

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*Standing, Waiver, Laches, and Appealability in Attorney Disqualification Cases*, 3 CORPORATION LAW REVIEW 82 (1980).

33. *Firestone Tire & Rubber Co. v. Risjord*, 449 U.S. 368 (1981).

34. *Flanagan v. United States*, 465 U.S. 259 (1984) (no appeal of granting of disqualification motion in criminal cases); *Richardson-Merrell, Inc. v. Koller*, 472 U.S. 424 (1985) (no appeal of granting of a motion to disqualify in civil case); *United States v. White*, 743 F.2d 488 (7th Cir. 1984) (no appeal of denial of motion to disqualify in criminal case).

35. A few courts of appeal have agreed to review lower court decisions using the extraordinary writ of mandamus. *Matter of Sandahl*, 980 F.2d 1118 (7th Cir. 1992); *In re American Airlines, Inc.*, 972 F.2d 605 (5th Cir. 1992).

36. See, e.g., *SWS Financial Fund A v. Salomon Brothers Inc.*, 790 F.Supp. 1392 (N.D.Ill.1992). The law firm had filed suit against the defendant for alleged violation of commodities regulations and the antitrust laws. The defendant was a *current* client of the firm's with respect to issues of compliance with commodities trading regulations. In spite of this, the court denied the defendant's motion to disqualify the firm. Judge B.B. Duff said that he wanted to avoid creating an incentive for companies to give several law firms small pieces of business so as to disqualify them later, although there was no evidence that had happened in this case. Should big law

Consider *Stratagem*, the case that ruled that lawyers cannot be adverse to affiliates of their corporate clients. *Stratagem* believed that lawyers who represent trade associations cannot be adverse to members of the trade association, even those these members are not the clients of the law firm, have never been represented by the law firm, and may never be represented by the law firm.

*Stratagem* was a case decided in the Southern District of New York. Nearly a decade before this opinion, the Second Circuit, which has jurisdiction over the Southern District, rejected the *Stratagem* reasoning. The Second Circuit, in fact, specifically stated that a "law firm that represents the American Bar Association need not decline to represent a client injured by an automobile driven by a member of the ABA."<sup>37</sup>

But the trial court in *Stratagem* could get away with its dubious interpretation of past precedent in its own circuit because there was no appeal as of right. What happened in *Stratagem* is not unusual. As I read the many disqualification cases that are reported each year, I am more and more struck by the increasing lack of uniformity, by the number of judges who create new rules, new exceptions, and even newer exceptions to the new exceptions — all in a context where there is unlikely ever to be any appellate decision to end the confusion and conflicts in the trial level. There truly is the death of precedent, because any trial judge who is of the mind to do so can take whatever position that the

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firms be treated in such cases as if they were defenseless victims? Note that the standard rule in such cases is to disqualify the law firm. Indeed, the ethics rules of the Northern District of Illinois (which are identical to the ABA Model Rules on this issue) prohibit a law firm from suing a concurrent client, even if the matters are unrelated. Rule 1.7, & Comment 3, Rules of Professional Conduct, Northern District of Illinois. But, the trial judge's ruling was not appealable.

37. *Glueck v. Jonathan Logan, Inc.*, 653 F.2d 746, 749 (2d Cir. 1981). *Stratagem*, oddly enough, cited the trial court in *Glueck* in support of its broad rule. See, 756 F. Supp. at 792, citing *Glueck v. Jonathan Logan, Inc.*, 512 F. Supp. 223, 227 (S.D.N.Y.), *aff'd on different grounds*, 653 F.2d 746 (2d Cir. 1981). The trial court's citation is a little misleading. It is true that the district court in *Glueck* promulgated a broad rule, at the page number of Federal Supplement that *Stratagem* cited. The Second Circuit, however, relied on a Seventh Circuit decision in another case, and specifically *did not rely on* or adopt the trial judge's reasoning. 653 F.2d at 749. The Seventh Circuit decision relied on a breach of a promise of confidentiality, not on any purported obligation to affiliates of clients. The Second Circuit, relying on that case, used the "substantial relationship" test and found that the law firm knew material and relevant *confidences* that would be compromised if it were not disqualified. 653 F.2d at 749-50.

*Stratagem*, 756 F. Supp. at 792, also relied on *Rosman v. Shapiro*, 653 F. Supp. 1441 (S.D.N.Y. 1987), which it described as a case where the law firm was disqualified because it represented a closely held corporation in which plaintiff and defendant each held 50% of the stock. In *Rosman*, the trial court found no relevant *confidences*, but it specifically ruled that the disqualified law firm had actually entered into an attorney client relationship with both *Rosman* and *Shapiro*. 653 F. Supp. at 1445. The *Rosman* trial court did not use any broad parent/subsidiary theory.

judge wishes regarding the application of the conflict of interest rules, confident that the chances of reversal are slim.

This development — the death of precedent — is significant, because it gives great prerogative and freedom to any judge faced with a motion to disqualify a law firm, while law firms and their clients are subjected to expensive litigation, with no hope for appeal. Instead of broad, unreviewable discretion, there is the need for brighter lines and clearer tests so that firms know what to do. A rule that says that the judge may, or may not, disqualify only after “shift[ing]” through “all the facts and circumstances”<sup>38</sup> gives little guidance to law firms and clients who, understandably, would like to know what the rules are so that they can obey them before a disqualification motion is ever filed. It is all right to “weigh the interests” only if the courts first calibrate the scales and inform us how the weight of the different interests is determined. Otherwise, law firms that are anxious to avoid conflicts of interest are at a competitive advantage compared to law firms that are willing to go up to, and occasionally cross, a vague ethics line.

With this background, now let us turn to the main issue, the problem of sister corporations.

### III. ETHICALLY PIERCING THE CORPORATE VEIL

Young children quickly learn that more is better than less. If ice cream is good, more ice cream must be better. But parents, who are a little more knowledgeable in such matters, know that more is better than less only at zero cost. If more ice cream causes the children to be sick, then more is not better than less.

So it is with ethics. Ethics is good, and we therefore might be tempted to think that more ethics is better. Yes, but we are not talking about morality. We are talking about disqualification rules. Overly strict or vague disqualification rules that impose unnecessary burdens of clients wishing to select their own counsel are not better than more carefully considered rules. The rules we impose on attorneys have costs to clients, to society, and to lawyers; if the benefits are outweighed by the costs, we should reevaluate the rule. The basic question is whether large corporations, with control over many other corporate entities, should have the power to leverage their already considerable economic power to limit their opponent's choice of counsel.

Such is the case with a rule imposing disqualification of a lawyer merely because he or she (or someone else in the same law firm) repre-

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38. *E.g.*, *Pennwalt Corp. v. Plough, Inc.*, 85 F.R.D. 264, 269 (D.Del. 1980).

sents, in an unrelated matter, a corporation that is affiliated with an adversary. I submit that *Stratagem* and those cases that follow it are simply wrong. There should be no *per se* rule prohibiting a lawyer or law firm from representing a client adverse to a corporation (let us call it Corporation A<sub>1</sub>) simply because the lawyer or law firm represents, in an unrelated matter, a different client (let us call it Corporation A<sub>2</sub>) that is affiliated with Corporation A<sub>1</sub>.<sup>39</sup>

If the law firm learned material client confidences from Corporation A<sub>1</sub> that are relevant in the case against Corporation A<sub>2</sub>,<sup>40</sup> then, as discussed above, the law firm is disqualified because of the need to protect client confidences<sup>41</sup>. But that is not the situation with which we are dealing. Imposing disqualification on the law firm in the hypothesized situation does nothing to protect the law firm's duty to treat client information as confidential because, by hypothesis, there are no relevant confidences to keep.

If Corporations A<sub>1</sub> and A<sub>2</sub> were the same corporation, then the normal ethics rules, as discussed above, would impose a *per se* disqualification because there is a duty of loyalty to a present client. However, by hypothesis, there is not one corporation but two or more corporations. The law firm has never represented Corporation A<sub>2</sub>, does not purport to represent Corporation A<sub>2</sub>, and has no attorney client relationship with Corporation A<sub>2</sub>. Corporation A<sub>2</sub> is represented by its own lawyer, whom it used to move to disqualify the opposing law firm.

Indeed, Corporation A<sub>2</sub> would be surprised to think that the law firm that it seeks to disqualify could be representing it or speaking for it. The factual circumstances surrounding the association (or rather, the lack of any association) between the law firm and Corporation A<sub>2</sub> have no indicia of an attorney-client relationship. Imposing disqualification on the law firm does nothing to protect the law firm's duty of loyalty towards Corporation A<sub>2</sub>, because the law firm has never represented Corporation A<sub>2</sub>, which has its own counsel. The law firm does represent Corporation A<sub>1</sub>, but Corporation A<sub>1</sub> is not a party to the lawsuit; if a motion is made to disqualify the law firm, it will be made by Corporation A<sub>2</sub>, an adverse party. Or, the motion might be made by the parent (Corporation A<sub>3</sub>) of Corporation A<sub>2</sub>.

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39. There is an "affiliation" in the sense that Corporation A<sub>1</sub> is a parent, subsidiary, wholly or partly owned by, or a sister corporation of, Corporation A<sub>2</sub>.

40. Or, another way of saying the same thing, if the two matters are substantially related. If the matters are the same matter or substantially related, the danger of a breach of material confidences or secrets is real.

41. See text at notes 20 to 23, *supra*.

The parent of this corporate family, of course, is not even a party to the law suit. And (unless the corporate veil is pierced) the parent will not be liable for any damages awarded. Moreover, if the subsidiary of Corporation A<sub>3</sub> collects any damages, the creditors of the subsidiary, not Corporation A<sub>3</sub>, has the priority to collect those damages. The subsidiary may be able to transfer some of the damage award to Corporation A<sub>3</sub>, but that transfer of money will usually have tax consequences. In short, for every purpose (except, apparently, for purposes of the law of conflicts) the law treats the parents, subsidiaries, and sister corporations as separate and distinct legal entities.

If there ever were a dispute between Corporation A<sub>2</sub> and Corporation A<sub>1</sub>, it would be clear that the law firm's loyalty lies only with Corporation A<sub>1</sub>, not Corporation A<sub>2</sub>. Even if one corporation is a wholly owned subsidiary of the other, the lawyer's duty is solely to Corporation A<sub>1</sub>, because the law recognizes two separate entities. For example, transfers of assets from one corporation to another may be a fraud on the creditors and the lawyer may not assist that fraud.<sup>42</sup>

On the other hand, if the default rule of ethics is that a lawyer who represents a corporation is automatically precluded from representing any other client who seeks a position that is adverse to the bottom line of any corporate affiliate of the client, the impact of the disqualification rule is significant. Such a default rule has serious drawbacks. It restricts the right of lawyers to practice in circumstances where the disqualified law firm has no access to any relevant confidential information and has never

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42. While there is little case law directly on point, the leading case on this issue involves a dispute between *unincorporated* divisions of the same company. *F.T.C. v. Exxon Corp.*, 636 F.2d 1336 (D.C. Cir. (1980)). Given the facts of that case, the court required the division (wholly owned by a corporation) to have its own counsel, whose loyalty would be to the division, not to the corporate owner. The court, in short, required the lawyers to treat a wholly owned subsidiary as a client separate and distinct from the parent corporation.

In *Exxon*, an F.T.C. administrative proceeding involved the "Drives Group," a "segment" of a wholly-owned subsidiary of Exxon. The Drives Group was not a separate corporate entity. The F.T.C. challenged Exxon's acquisition of the Drives Group and sought its divestiture. The trial court prohibited Exxon's in-house and retained counsel from having any attorney-client relationship with the Drives Group.

The D.C. Circuit acknowledged that the Drives Group "has no independent corporate existence." 636 F.2d at 1346. But it rejected Exxon's argument that there could be no conflict between the Drives Group and Exxon even though "the Drives Group is now solely owned by Exxon." 636 F.2d at 1345. If the Drives Group *became* a separate corporate entity and if it were divested, then — said the D.C. Circuit — it would be a competitor of Exxon. 636 F.2d at 1346. The court thus affirmed this portion of the lower court order and did not reach the F.T.C.'s argument that it would be unethical for Exxon's counsel to also represent the Drives Group. 636 F.2d at 1346 n. 32. See also, American Law Institute, Restatement of the Law Governing Lawyers, Third, § 212, Comment *d*, and Reporter's Notes to Comment *d*, *Conflicting interests of affiliated organizations* (Tent. Draft No. 4, April 10, 1991).



represented the adverse party who is now moving to disqualify it. This rule — treating separate corporations as one entity for conflict purposes — serves to limit the freedom of a client to hire a lawyer of her choice.

A corporation does not normally have *carte blanche* power to limit the right of a law firm to represent interests that are adverse to third parties.<sup>43</sup> The corporate client (which is affiliated with the adverse party) is not a party to the lawsuit, and the law firm's client (which is a party to the lawsuit) does not object to the law firm representing it. The affiliate of the corporate client (who is the adversary in the lawsuit) is the only party in the lawsuit who objects.

It is not sufficient to retort that the lawyer can always secure consent. First, consent from whom? At the time that the law firm initially represents Corporation A<sub>1</sub>, that client (Corporation A<sub>1</sub>) is in no position to waive the rights of Corporation A<sub>2</sub>. At the time that representation is begun, Corporation A<sub>2</sub> may not even exist.

Second, when is this consent supposed to be secured? Consider the original hypothetical, where a law firm that occasionally represents Taco Bell in real estate matters would like to sue KFC on behalf of a tort plaintiff injured by a KFC delivery truck. At the time that the lawsuit is brought, the corporate parent, *e.g.*, Pepsico (Corporation A<sub>3</sub>) has no incentive to give consent. It is strategically useful to deny consent because disqualification imposes burdens on the opposition in the form

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43. The Model Rules reflect a reluctance to allow third parties or other lawyers the power to restrict the right of a lawyer to practice law because such a restriction "limits [the lawyers'] professional autonomy" and also "limits the freedom of clients to choose a lawyer." ABA Model Rule 5.6, Comment 1. For example, the Rules limit the ability of a law firm to restrict the right of its members to practice law after termination of the relationship with the partnership except when the restrictions are incident to provisions concerning retirement benefits. ABA Model Rule 5.6(a).

The Rules also prohibit a lawyer from agreeing to restrict his or her right to practice as part of a settlement of a controversy "between private parties." ABA Model Rule 5.6(b). Although the Rules explicitly refer to "private parties," an ABA Formal Opinion — emphasizing the importance of the lawyer's freedom to practice — regards that language as merely descriptive, not prescriptive. ABA Formal Opinion 95-394 (July 24, 1995). Thus, the Formal Opinion held that it was unethical for a lawyer to agree to restrict her right to practice as part of a settlement with a public agency, even though the agency is not a "private party" as described in Model Rule 5.6(b).

As discussed above, clients and lawyers can always agree that the lawyer will not (or will) represent other clients who are adversaries of an affiliate. That is not to say that clients have *carte blanche* power to impose on their lawyers blanket restrictions on their ability ever to represent a particular person or entity. A xenophobic client, for example, cannot require his lawyer never to represent foreigners. A racist client cannot require its law firm never to represent blacks. In order for the restriction on legal practice to be valid, it should reasonably relate to legitimate client interests. An analogy may be made to choice of law rules. Two parties can agree by contract to be bound by the laws of the jurisdiction of State A or State B, assuming that the parties have reasonable contacts with either jurisdiction. But two parties have no right to agree to be bound by the laws of State X (a jurisdiction with which neither party has any connection), just because one of the parties likes the laws of State X.

of increased costs. The opposing party has to find and educate new attorneys. The law should not be reluctant to impose such costs if the policies behind the ethics rules demand it. But those policies do not demand it in most situations of conflicts involving corporate families. At the time that the law firm begins its representation of Taco Bell (Corporation A<sub>2</sub>), the law firm may not even know of the relationship with KFC (Corporation A<sub>1</sub>), or that relationship may not yet exist.

In weighing the interests, it is also important to understand that the corporate affiliate of the client and the rest of its corporate family are not without remedies. We are dealing with corporate families. That means that the clients are sophisticated: they are not only operating in the corporate form but they are operating within a corporate family structure. Such clients are often represented by inside counsel before they ever decide to hire any outside counsel. There are various self-help methods that are reasonable for a sophisticated corporate client to use to protect itself and to protect its affiliates.

For example, the corporate-client, at the time of the initial engagement letter, can always stipulate that, as a condition of representation, the law firm agrees to take no cases adverse to a list of affiliates of the corporate client.<sup>44</sup> The client knows better than the lawyer who the affiliates are and how close the relation with the affiliate must be before the client demands that the lawyer not represent interests adverse to these sister corporations. If the corporate-client is later purchased by another corporation or in some other way becomes part of another corporate family, when the corporate-client makes that move to become part of a different corporate family, it will make the change subject to its earlier waiver.

The corporate-client, by emphasizing that it intends to ignore the default rule proposed here, and that it wishes to impose a broad view of disqualification upon the law firms that it hires, puts the lawyers on notice that this particular retention is subject to major opportunity costs. The law firm, in response, may wish to charge their fees accordingly, because the retention imposes special opportunity costs on the law firm. These opportunity costs are represented by the business lost due to the law firm agreeing, by contract, to be bound by a broad view of conflicts.

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44. Now that law firms and corporate clients are becoming more aware of the sister corporation issue, we should expect to see more of these engagement letters in the future. In the meantime, courts must create a default rule when no engagement letter details how the issue should be resolved. See Maureen Castellano, *ABA Draws Line on Corporate Conflict Rules*, *LEGAL TIMES OF WASHINGTON, D.C.*, April 3, 1995, at 2, referring to a law firm that, for approximately the last three years, has inserted a provision in its standard engagement letters to corporate clients confirming that the firm represents the parent company but has not been retained to represent and is not representing any of the company's subsidiaries.

Alternatively, if the corporate client says nothing in its engagement letter, then it should be treated as waiving any right to preclude the law firm from representing a party adverse to an affiliate of the client, merely because it is an affiliate. If the client says nothing, the default rule is simply that the client has no right to preclude automatically the law firm from representing a party adverse to an affiliate.<sup>45</sup>

The corporate-client, in short, is simply asked to tell the law firm, at the time of the initial retention, what it expects the law firm to avoid as a conflict of interests. The law firm continues to be bound to hold inviolate the confidences of its corporate client, and cannot represent anyone else where those confidences are relevant. The law firm, thus, is always bound by its duty of confidentiality, but is not automatically bound (unless the engagement says otherwise) to treat — for purposes of the duty of loyalty — the corporate affiliate of a client as if that affiliate (a separate corporate entity) were the client itself.

In addition, whether or not there is an engagement letter, if a corporate client later determines that it wishes to impose a broad notion of disqualification, if it is offended that the law firm is representing another client in a matter adverse to the interests of the affiliate of the corporate client, and if the law firm does not agree to be bound by the restrictions, the offended client can always end its retention and terminate the lawyer. While the lawyer cannot merely walk away from the client without reason,<sup>46</sup> the client can always terminate the lawyer for any reason, or for no reason.<sup>47</sup> These self-help, market-oriented mechanisms, lessen the need for a *per se* default rule that always favors disqualification.

ABA Formal Opinion 95-390, *Conflicts of Interest in the Corporate Family Context*<sup>48</sup> is the major effort of the ABA Standing Committee on Ethics and Professional Responsibility to deal with the question of conflicts of interest involving affiliates of corporate clients. The Committee

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45. In other words, when the client hires the law firm, the client agrees to waive, *in futuro*, any objections based on a breach of loyalty if the law firm later is adverse to an affiliate of the client. However, the law firm is not asking the client to waive, *in futuro*, any objections based on a breach of confidences. ABA Formal Opinion 93-372, *Waivers of Future Conflicts of Interest* (April 16, 1993), notes that "courts are very reluctant to conclude from a prospective waiver an agreement by the client to waive rights of confidentiality."

To the extent that the corporate family is large and far-flung, and therefore more likely to be concerned about the sister corporation problem, it is also more likely to have its own house counsel who can advise it whether it should insist that the law firm be loyal not only to the law firm's client but to corporate affiliates of the law firm's client. It also should have greater leverage and bargaining power. The law firm can also advise the client about the terms of the engagement letter.

46. *E.g.*, ABA Model Rule 1.16.

47. The lawyer-client relationship is not an agency coupled with an interest.

48. Decided on January 25, 1995.

debated the question for two years before issuing its Opinion.<sup>49</sup> The resulting effort signaled a deeply divided Committee, with four of the ten members filing sharply worded opinions that dissented in whole or in part.<sup>50</sup>

The majority clearly rejected any *per se* rule requiring disqualification, thus joining similar ethics opinions on the state level.<sup>51</sup> However, it volunteered, "the circumstances of a particular representation may be such that the corporate client has a reasonable expectation that the affiliates will be treated as clients, either generally or for purposes of avoiding conflicts, and the lawyer is aware of the expectation."<sup>52</sup>

49. Maureen Castellano, *ABA Draws Line on Corporate Conflict Rules*, LEGAL TIMES OF WASHINGTON, D.C., April 3, 1995, at 2, col. 1.

50. Deborah A. Coleman filed an opinion concurring and dissenting; Richard L. Amster and Lawrence J. Fox each filed dissenting opinions; and Kim Taylor-Thompson concurred in the dissents of Messrs. Amster and Fox. The majority opinion was the product of the Committee and did not indicate an author, though the primary author was David Isbell. Maureen Castellano, *ABA Draws Line on Corporate Conflict Rules*, LEGAL TIMES OF WASHINGTON, D.C., April 3, 1995, at 2, col. 1.

51. E.g., New York County Lawyers' Association, Committee on Professional Ethics, Opinion 684 (July 8, 1991), ruled that a law firm that represents a parent corporation may also represent a party with interests adverse to a subsidiary of the parent corporation in an unrelated matter if: (1) the law firm does not have access to relevant confidential information adverse to the subsidiary; (2) if there is no attorney-client relationship between the law firm and the subsidiary; and (3) if the parent-corporation's interests are not materially affected by actions against its subsidiary.

California State Bar Standing Committee on Professional Responsibility also promulgated Formal Opinion 1989-113 (July 6, 1990), held that a law firm may undertake representation adverse to a wholly-owned subsidiary of the law firm's corporate client if the parent corporation is not the "alter ego" of the subsidiary and the subsidiary has not revealed confidential information to the law firm with the expectation that it would not be used adversely to the subsidiary. This Opinion also states: "The percentage of ownership of stock, while a factor to consider, is by no means itself determinative."

Maryland Bar Association, Committee on Ethics, Opinion 87-19 (undated) concluded that the lawyer for the subsidiary of a publicly traded corporation could ethically handle a suit against another subsidiary of the same company.

52. Prior to the quotation in the text, the Committee said:

It is the Committee's opinion that the Model Rules of Professional Conduct do not prohibit a lawyer from representing a party adverse to a particular corporation merely because the lawyer (or another lawyer in the same firm) represents, in an unrelated matter, another corporation that owns the potentially adverse corporation, or is owned by it, or is, together with the adverse corporation, owned by a third entity. The fact of corporate affiliation, without more, does not make all of a corporate client's affiliates into clients as well.

See also, ABA Formal Opinion 95-390, *supra*, footnote omitted, where the Committee states that if the affiliate is only partially owned by the parent, that is "a variable that may affect the result in a particular case." (emphasis added).

But the Committee majority may appear to be ambivalent, because, right after making the statement quoted in the text, it then announced:

[T]he Committee believes that as a general matter, in the absence of a clear understanding otherwise, the better course is for a lawyer to obtain the corporate client's consent before the lawyer undertakes a representation adverse to its affiliate.

The Committee's opinion reflects a problem that may be inherent in any product of a committee dealing with a controversial issue: the problem is vagueness, ambivalence, inconclusiveness, ambiguity. This uncertainty imposes transaction costs on any disqualification, because we may not know, until after extensive litigation, whether the lawyer should be disqualified.

Ambiguity results in a perverse effect, giving a competitive advantage to law firms that are willing to push to see how close they can get to the vague line. More careful firms, those wishing to avoid even a chance that they may be found to have engaged in an unethical representation, are forced to disqualify themselves from these cases. The law should not favor the less careful firms unless there is a good reason why the line drawing must be vague. In this case, as we shall see, we can draw brighter lines.

The ABA Formal Opinion tells us that, in determining if a lawyer represents a corporate affiliate of a client, there is no "clear-cut per se rule," but rather one must look at "the particular circumstance." In looking at a particular circumstance, we are first told that the lawyer must not simply consider the terms of the engagement letter. The engagement letter is the basic contract with the client. One would think that a clear engagement letter should end the matter. If the corporate client has waived any argument that the law firm must be loyal to any affiliates of the corporate client, that term of the engagement letter should govern.

In any event, the ABA Formal Opinion advises that we must also consider "whether the circumstances are such that the affiliate [of the client] has reason to believe, on the basis of the nature of the lawyer's dealings with it, that it has a client-lawyer relation with the lawyer." If the affiliate of the corporate client believes that it has a client-lawyer relationship with the lawyer, then the majority appears to find a conflict.

On the other hand, if the lawyer passes this hurdle, that is, if the affiliate of the corporate client is not the lawyer's client, then the affiliate may still argue that the lawyer's representation of one client in a lawsuit against the affiliate of another client is adverse because of the "potential economic impact on the affiliate entails an impact on the corporation itself." In response to this argument, the Committee declared that this economic impact is "indirect," not direct: "Although there is room for dispute on the point, we believe the better view is that the adverseness in such circumstances is indirect, and not direct."

The classification that the Ethics Committee insisted on is significant. If the adverseness is "direct," then, under Model Rule 1.7(a), both clients must consent to the representation. Thus, if our hypothetical law

firm represents a client in a tort claim against Kentucky Fried Chicken, and this adverseness to Taco Bell (the real client of the law firm, and also a corporate affiliate of KFC) is "direct," then Taco Bell would have the right to veto that representation, because Taco Bell and KFC are both subsidiaries of Pepsico. However, if the adverseness is "indirect," as the Committee insists, then Model Rule 1.7(b) applies, and, in the hypothetical that I have presented, the law firm suing KFC need secure consent only from the tort plaintiff, not from Taco Bell or KFC. The law firm can then take the case if the tort plaintiff consents and the lawyer reasonably believes that the representation will not be adversely affected.<sup>53</sup>

Unfortunately, although the Model Rules have an extensive "Terminology" section placed just before Model Rule 1.1, it supplies no definition and offers no litmus test to define these crucial terms, "indirect" and "direct." The Committee tells us that the adverseness is "indirect" because the "immediate impact" of the lawsuit is on the affiliate and is "only derivatively upon the client." This distinction appears metaphysical, a definition pretending to be a syllogism.

The dissent criticized the majority as pontificating, substituting a pronouncement for reasoning. If the client of the affiliate writes the settlement check, does that make the adverseness "direct," because then there is an immediate impact? The Committee does not consider such questions but, amazingly, claims that the phrasing of Rule 1.7(a), which uses the "direct" language, "is not ambiguous," and the difference between "direct" and "indirect" is a "bright line striking a balance between the interests of lawyer and client."

I am reminded of the cartoon inventions of Rube Goldberg, who drew wildly complex contraptions that accomplished trivial ends. A typical Rube Goldberg device to shell an egg is tripped when one picks up the morning paper from the kitchen table, which causes a string to be pulled to open the door of a bird cage, releasing a bird that follows a trail of birdseed to a platform. The bird then falls off the platform into a pitcher of water, which splashes on a flower, causing it to grow, thereby pushing up a rod that causes a pistol to fire. A monkey scared by the pistol shot hits his head against a bumper attached to a razor that cuts into the egg, loosening the shell, which falls into a saucer. The inventions that Rube Goldberg designed worked every time.<sup>54</sup> Was the inevi-

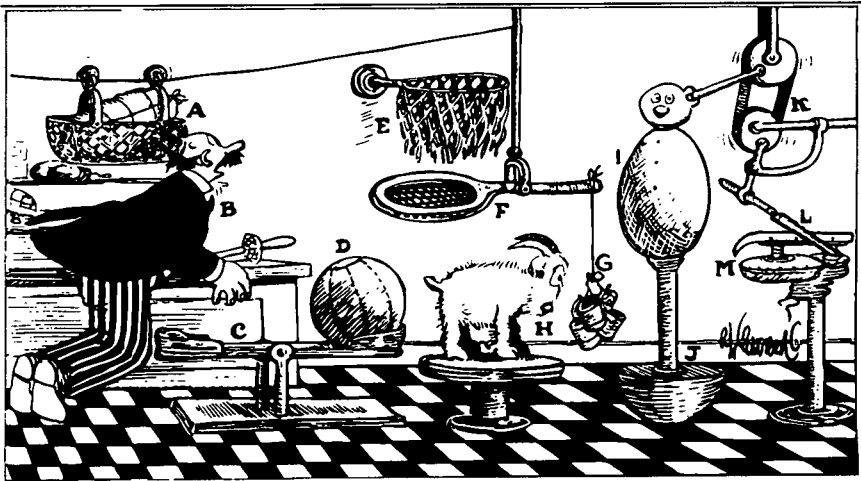
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53. See, ABA Model Rule 1.7(a), (b).

54. MICROSOFT ENCARTA, (CD ROM 1994), and MICROSOFT BOOKSHELF (CD ROM 1994), drawing information from *The American Heritage Dictionary of the English Language*, Third Edition (Houghton Mifflin Company 1992) and *The Concise Columbia Encyclopedia* (Columbia University Press 1991).

table effect direct or indirect? If the time between the cause and effect is convoluted but inevitable, and the time period is quick (or lengthy), does that make it direct?<sup>55</sup>

In determining whether the affiliate of the corporate client is also a client, and whether any adverseness is “direct” or “indirect,” another important provision to consider is Model Rule 1.13. This Rule governs cases where an organization (such as a corporation, a trade association, a union, or a partnership) is a client. Rule 1.13 imposes no *per se* rule that treats the affiliates of an entity as the client of a lawyer who represents the entity. On the contrary, to the extent that there is a *per se* rule, it is to the contrary: the client is the corporate entity, not the affiliate, parent, or subsidiary of the entity. Thus, Model Rule 1.13(a) provides: “A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.” These constituents, such as “[o]fficers, directors, employees and shareholders,”<sup>56</sup> the Comment emphasizes, “are [not] the clients of the lawyer.”<sup>57</sup>



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55. At another point the Committee said that “directness” relates to the “closeness of the connection between the lawyer’s actions and the adverse effect on the client.”

56. Model Rule 1.13, Comment 2. The origins of Rule 1.13(a) lie in Ethical Consideration 5-18 of the ABA Model Code of Professional Responsibility (as amended through 1981), which provided that:

A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and *not to a stockholder*, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interests and his professional judgment should not be influenced by the personal desires of any person or organization.

57. ABA Model Rule 1.13, Comment 3.

The lawyer, in short, represents the entity, *not* its constituents, such as shareholders. The case where one corporation is the subsidiary of one or more other corporations is merely a situation where the shareholder of the corporation happens to be another corporation. But the client is the entity; the client is not the shareholders, even if the shareholders are corporations. Thus, Comment 8 warns that “the organization’s interest may be or become adverse to those of one or more of its constituents.” In such cases, the lawyer should advise the constituent that “the lawyer cannot represent such constituent . . .” The lawyer, however, can continue to represent the corporation. Rule 1.13 objects to the notion that a law firm is in a *per se* conflict whenever it advances a position that is adverse to a constituent element (a corporate affiliate) of one of its clients.

To preclude the law firm from representing a client (e.g., Client Alpha) adverse to Corporation A<sub>2</sub> merely because the law firm also represents Corporation A<sub>1</sub> in an unrelated matter serves to deprive Client Alpha of its choice of its own counsel. The law sometimes does that, but it does not do so cavalierly. The reason must be sufficiently weighty. The reason in this case cannot be to protect the confidential information of Corporation A<sub>1</sub> (because we have assumed that the law firm knows no relevant confidential information), nor is the reason to protect the law firm’s loyalty towards Corporation A<sub>1</sub>. The law firm, after all, is not suing Corporation A<sub>1</sub>. It is adverse to Corporation A<sub>2</sub>, and that corporation is merely the shareholder of Corporation A<sub>1</sub>. So what is the reason to treat the affiliate of a client as the client itself?

The dissents filed to ABA Formal Opinion 390 thought that they had the reason. The dissenters argued that it is sophistry to think of Corporations A<sub>1</sub> and A<sub>2</sub> as separate entities, because affiliated corporations have a financial relationship with each other.<sup>58</sup> Corporate “families are financially totally inter-dependent,” and the “location of a corporate family’s losses are totally irrelevant to the impact on the bottom line.”<sup>59</sup> The distinction between different parts of the same corporation and different corporations in a corporate family “exalts form over substance.”<sup>60</sup>

Granted, whatever happens financially to corporation in the corporate family will affect the bottom line but that cannot be the test for determining who is the lawyer’s client and to whom the lawyer owes a

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58. Dissents of Richard L. Amster and Lawrence J. Fox.

59. Lawrence J. Fox, dissenting.

60. Dissent of Richard L. Amster (“an elevation of form over substance”); dissent of Lawrence J. Fox (“exalts form over substance”).



duty of loyalty.<sup>61</sup> Let us assume what should be a clear case of financial interdependence: Corporation A<sub>1</sub> (the parent) agrees to pay the legal bills of the counsel for Corporation A<sub>2</sub>. That arrangement is similar to the typical insurance relationship, where the insurer pays the legal fees of the lawyer for the insured. A corporation (or private individual) buys an insurance policy that obligates the insurer to pay the damage award, if any, and also to pay the costs of defense.

What happens to the insured affects the bottom line of the insurance corporation. Although the insurance corporation pays the lawyer's fees, the lawyer's ethical obligation is to the insured, not to the insurer. The insurer merely pays the bills of the lawyer. The insurer is also obligated to pay any judgment to the plaintiff, up to the policy limits. If the suit is for less than the policy limits (not an unlikely occurrence), the insurer is in a position that is financially similar to the parent of a wholly owned subsidiary. Every penny of the lawsuit affects the bottom line of the insurer. Yet, these financial obligations confer on the insurer no right to control the professional judgment of the lawyer for the insured.<sup>62</sup> Even

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61. Cf. *Board of Education v. Nyquist*, 590 F.2d 1241 (2d Cir. 1979), involved a case where the general counsel for the state teachers' union represented three male physical education teachers in a suit alleging that maintenance of separate seniority lists for male and female physical education teachers was illegal. Female teachers, who were also members of the same union, would be disadvantaged if the men prevailed. Thus they moved to disqualify the men's union counsel. Because of the union, the female teachers were paying, in part, for their opponent's legal expenses. Nonetheless, the Second Circuit held that there should be no disqualification and reversed the trial court. There was no danger that the union counsel had any unfair advantage because he had not gained any relevant, material, confidential information from the female teachers due to his position as union counsel. Nor was there any evidence that the lawyer's duty of loyalty to the male clients would be diminished. 590 F.2d at 1247.

62. ABA Model Rule 1.8(f). See, e.g., RONALD D. ROTUNDA, *PROFESSIONAL RESPONSIBILITY* 68-69 (West Publishing Co., Black Letter Series, 1995); Robert O'Malley, *Ethics Principles for the Insurer, the Insured and Defense Counsel: The Eternal Triangle Reformed*, 66 *TULANE L. REV.* 511 (1991).

The American Law Institute's proposed RESTATEMENT OF THE LAW GOVERNING LAWYERS concurs. See ALI, RESTATEMENT OF THE LAW (THIRD), THE LAW GOVERNING LAWYERS § 215 (Council Draft No. 11, vol. 2, Sept. 29, 1995) & Comment *f*, *Representing insured*, which states that "[t]he lawyer represents the insured." This is so even though the "lawyer might be designated by an insurer to represent the insured under a public liability insurance policy in which the insurer undertakes to pay claims and provide a defense." Even if the insurance contract states that the lawyer represents the insurer, the Comment explicitly warns: "The insurer is not, by the fact of designation alone, a client of the lawyer."

When there are differences or conflicts between the interests of the insurer and insured (e.g., when there is a question whether the claim is within the coverage of the policy, or when there is a claim in excess of policy limits), the lawyer's duty of loyalty is not to the insurer. Comment *f* is quite specific:

[A] lawyer designated to defend the insured may not reveal adverse confidential client information of the insured to the insurer without explicit consent of the insured (see § 112). That result follows whether or not the lawyer also represents the insurer as co-

though the insurance company's payment of legal fees affects the "bottom line"<sup>63</sup> of the insurer, the basic rule is that the lawyer represents the insured, not the insurer.<sup>64</sup>

There is no logical reason why members of corporate families should be treated as one client, while the insurer and the insured are recognized as two separate clients. Moreover, the separate legal existence of corporations is something that the law continually recognizes. The reasons why corporations create corporate families (parent, subsidiaries, and sister corporations) is because the law confers various substantive benefits on corporate entities that are created and treated as separate entities.<sup>65</sup> It is not a matter of mere form devoid of substance.

Those who take advantage of the benefits of multiple incorporations should also assume the burdens. Corporations, like other persons, have to accept the bitter along with the sweet. Why should large corporations be able to leverage their economic power to disqualify lawyers by creating corporate families? They should not be able to have it both ways, by conducting business through a series of corporate entities, perhaps with a complex, ever-changing and bewildering organizational chart, using an impenetrable fog of subsidiaries and affiliates when it appears advantageous to do so, and then argue (when someone else *relies* on the legal and economic separateness of these entities) that none of this really matters, that the corporate family really is a single entity for one purpose only — for the purpose of applying the conflicts of interest rules in a way that prevents a client from choosing a lawyer who also happens to represent a corporation affiliated with this far flung corporate empire.<sup>66</sup>

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client and whether or not the insured has asserted a 'reservation of rights' with respect to its defense of the insured (*compare* § 112, Comment 1 (confidentiality in representation of co-client in general)).

In short, for any purpose that really matters, the lawyer should treat the insured as the real client.

63. *Stratagem Development Corp. v. Heron International N.V.*, 756 F.Supp. 789, 792 (S.D.N.Y. 1991).

64. *E.g.*, *Allstate Insurance Co. v. Keller*, 149 N.E.2d 482 (Ill. App. 1958); *Employers Casualty Co. v. Tilly*, 496 S.W.2d 552 (Tex. 1973). American Law Institute, *Restatement of the Law Governing Lawyers* (Third), § 215, Comment c; *see also*, Reporter's Note to Comment c (Tent. Draft No. 4, April 10, 1991).

65. *See, e.g.*, notes 1 & 39-42, *supra*.

66. One should realize that the law firm may not know, and may have no reasonable means of knowing, who are all the members of a corporate family that is constantly changing over the years. *See*, *Gould, Inc. v. Mitsui Mining & Smelting Co.*, 739 F.Supp. 1121, 1125-26 (N.D. Ohio, 1990); *Pennwalt Corp. v. Plough, Inc.*, 85 F.R.D. 264, 266 (D.Del.1980). ABA Formal Opinion 95-390 recognizes this problem and opines that a "lawyer who has no reason to know that his potential adversary is an affiliate of his client will not necessarily violate Rule 1.7 by accepting the new representation without his client's consent."

It is interesting that the dissenters in ABA Formal Opinion 95-390 have no dispute with earlier ABA Formal Opinions that apply the entity theory to partnerships and trade associations.<sup>67</sup> Yet, partners, in either a limited or general partnership also have financial relationships with each other, just like affiliated corporations have financial relationships with each other. Nonetheless, the normal rule for ethical purposes is that the lawyer for a partnership represents the partnership as an entity, whether or not the partnership is treated as an entity or an aggregate under state law.<sup>68</sup> If there is a lawsuit between a partner and the partnership, each side has its own lawyer.

It is not surprising that a lawyer for the partnership does not automatically represent all of the partners of that partnership.<sup>69</sup> If the law were otherwise, then a partnership could never be represented by counsel if it were in a dispute with one or more of its partners because then, the lawyer who represented the partnership would be deemed to also represent the adversary (the partner with whom the partnership had its dispute), and therefore be involved in a conflict.

Similarly, a trade association is treated as an entity, with the lawyer representing that entity and not the constituent members of the entity, even though the trade association would not exist but for the financial contribution and membership of its individual members.<sup>70</sup> The dissent in ABA Formal Opinion 95-390 had no trouble treating a partnership or a trade association as an entity, even if state law treats these organizations

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67. Formal Opinion 91-361, *Representation of a Partnership* (July 12, 1991); Formal Opinion 92-365, *Trade Associations as Clients* (July 6, 1992).

68. E.g., ABA Formal Opinion 91-361, *Representation of a Partnership* (July 12, 1991); ABA Model Rule 1.13 & Comment 2; Rule 3-600, California Rules of Professional Conduct & "Discussion," 1st paragraph to Rule 3-600, *reprinted in*, T. Morgan & R. Rotunda, 1995 SELECTED STANDARDS ON PROFESSIONAL RESPONSIBILITY 296-98 (Foundation Press, 1995).; *Responsible Citizens v. Superior Court*, 16 Cal.App.4th 1717, 1730-31, 20 Cal. Rptr.2d 756, 764 (Ct.App.5thDist. 1993); *Kapelus v. State Bar*, 44 Cal.3d 179, 242 Cal. Rptr. 196, 745 P.2d 917 (1987).

69. The circumstances would be different if the lawyer for the partnership promised or led one or more of the individual partners to believe that the lawyer was representing their interests. Cf. *Westinghouse Electric Co. v. Kerr-McGee Corp.*, 580 F.2d 1311, 1319-21 (7th Cir. 1978), *cert denied*, 439 U.S. 955 (1978). In that case, the law firm for the trade association *promised* its individual members that it would treat information from them as protected by the attorney client privilege, and then — on the strength of that promise — did obtain confidential information that was material to a substantially related case that the law firm brought against several members of the trade association. The court ruled that the law firm should be disqualified in order to protect these confidences.

70. ABA Formal Opinion 92-365, *Trade Associations as Clients* (July 6, 1992).

as an aggregate. Yet the dissent objects to treating a corporation as an entity, even though state law says that it is an entity.<sup>71</sup>

Those who argue that we must not treat the subsidiaries or parents or sisters of a corporation as separate entities are really arguing that — only for purposes of the rules of ethics and of disqualification — we must *always* pierce the corporate veil. The question is, WHY? Why automatically pierce the corporate veil in ethics cases but not in other situations?

In corporate law, courts may pierce the corporate veil but they do not do so casually. Corporate law normally treats each corporation as a separate, incorporeal entity, and thus various rules determine when the rare circumstances exist that allow the court to pierce the corporate veil, thereby circumventing a fundamental legal principle of corporate law. Courts may disregard the corporate entity only in certain cases, when necessary to avoid misuse of the law of incorporation, such as when a subsidiary is undercapitalized.<sup>72</sup>

For example, in *United States v. Jon-T. Chemicals Inc.*,<sup>73</sup> the Fifth Circuit pierced the corporate veil and found that the parent was the “alter ego” of the subsidiary: all of the directors and officers of the two corporations were identical; the parent paid many of the subsidiary’s obligations; the parent made substantial loans to the subsidiary without interest charges or collateral requirements; the corporations filed consolidated financial statements and tax returns; the subsidiary utilized the parent’s equipment and offices without compensating the parent; and the subsidiary employees’ salaries were paid by the parent. These facts constituted the touchstone. There is no automatic piercing simply because one corporation is wholly owned by the other.

In ethics as in corporate law, if one is to pierce the corporate veil for the purpose of deciding a disqualification issue, one should determine when are the circumstances such that public policy demands a piercing. A similar analysis should apply to disqualification issues. ABA Model

71. Mr. Fox, in his dissent, makes the point that the distinction between partnerships and trade associations, on the one hand, and affiliated corporations on the other, is that “we are talking about a wholly owned corporate family. The only analogies that would be apt here are a single partner partnership or a single member trade association.” However, even when one corporation wholly owns another, the law treats them as separate entities with separate (and sometimes adverse) obligations. See discussion at notes 39-42, *supra*.

72. *Bucyrus-Erie Co. v. General Products Corp.*, 643 F.2d 413 (6th Cir. 1981); and *see Lucas v. Texas Industries, Inc.*, 696 S.W. 2d 372 (Tex. 1984) (though parent was not held liable, the court stated that it might pierce the corporate veil and hold the parent company liable if the subsidiary was not reasonably capitalized in light of the nature and risk of its business); *St. Paul Fire and Marine Ins. Co. v. Pepsico, Inc.*, 884 F.2d 688 (2d Cir. 1989).

73. *U.S. v. Jon-T. Chemicals Inc.*, 768 F.2d 686 (5th Cir. 1985).

Rule 1.7 invites such an analysis. Rule 1.7(a) applies a strict rule of disqualification only in certain cases (if the lawyer represents one client “directly adverse to another client”). Only in such cases is there a *per se* disqualification unless the lawyer can secure the consent of *both* clients.<sup>74</sup> Even consent from both clients will normally not cure a situation where the lawyer represents a client in one case while suing that client in another case.<sup>75</sup>

I have argued that the lawyer in our basic hypothetical is not prohibited, by ABA Model Rule 1.7(a) from taking a tort case against KFC (which is not a client) just because she has engaged in title work for Taco Bell (even when KFC and Taco Bell are both owned by Pepsi). Our hypothetical lawyer, in taking the tort action against KFC, is taking no position adverse to Taco Bell.

However, Model Rule 1.7(b) is also applicable. If the attorney’s representation of the plaintiff against KFC might be compromised or, in the words of that rule, “materially limited” by her obligations to Taco Bell, then there is a conflict that requires disqualification unless there is first, consent by the tort plaintiff,<sup>76</sup> and second, a reasonable self-determination by the lawyer that her representation will not be “adversely affected.”<sup>77</sup> In other words, not all conflicts can be cured by consent. Even if the tort plaintiff would consent, if a reasonable lawyer would conclude that her representation would be adversely affected by her obligations to Taco Bell, then she cannot take the case.

The lawyer should not take the case if she really treats KFC or Pepsi as her client, even though Taco Bell is the nominal client. In ascertaining whether a wholly-owned (or substantially-owned) corporate subsidiary should be considered an entity separate from the parent, the lawyer should evaluate the separateness of the entities involved, establish whether corporate formalities are observed, determine the extent to which each entity has distinct and independent management and board of directors, and only then should conclude whether, for legal purposes, one entity should be considered the alter ego of the other.<sup>78</sup>

For example, one situation where — for the purposes of the rules of ethics — it may be appropriate to pierce the corporate veil occurs when

74. ABA Model Rule 1.7(a)(2).

75. ABA Model Rule 1.7, Comment 3.

76. ABA Model Rule 1.7(b)(2).

77. ABA Model Rule 1.7(b)(1).

78. *Teradyne, Inc. v. Hewlett-Packard Co.*, 20 U.S.P.Q.2d (BNA) 1143, 1991 WestLaw 239940, \*4, U.S. Dist. LEXIS 8363 (N.D.Cal. June 6, 1991), referring to Formal Opinion No. 1989-113 of the State Bar of California’s Standing Committee on Professional Responsibility and Conduct (July 6, 1990).

the parent corporation has a very integrated legal department with similar personnel. If the two affiliated corporations do not have separate legal departments, and have the same people who retain and supervise the outside lawyer, then that is a crucial factor to consider in order to determine if it should be appropriate to treat the two corporations as one for ethical purposes.<sup>79</sup> Just as observing corporate formalities are important in corporate law, so too are they important in applying the law of ethics.

Consider *Pennwalt*,<sup>80</sup> where the court noted that a conflict involving the affiliated corporations would develop because the two sister corporations were being reorganized so that they would be in the same division, with the Chief Executive Office of that division sitting on both boards of directors. The legal departments were also being consolidated so that there would be one legal department under the active supervision of the same attorney.<sup>81</sup> Though the court refused to disqualify for other reasons (the alleged conflict had been "thrust upon" the law firm by the merger activities of the corporation now seeking to disqualify the law firm), the existence of similar personnel is relevant. In other words, it may be difficult for a lawyer to visit with the general counsel of the parent corporation in the morning, to discuss the settlement tactics in a case where the law firm is *defending* the subsidiary of the parent corporation (who share the same legal department), and then (later that afternoon) for that lawyer to meet with the same general counsel, pound on the table, and threaten punitive damages while discussing settlement in a case where the law firm is on the opposite side, *suing a different subsidiary* of the same parent corporation, all of whom are represented by the same general counsel.

Another situation involves the case where the failure to disqualify the law firm would interfere with or taint the results of the litigation. Consider *Gould, Inc. v. Mitsui Mining & Smelting Co.*<sup>82</sup> In that case,, the Jones, Day law firm represented plaintiff Gould suing various defendants, including Pechiney, alleging unfair competition. Pechiney moved to disqualify Jones, Day because Jones, Day also represented (in unrelated patent matters) IG Technologies, a wholly-owned subsidiary of Pechiney. The court noted that, "Jones, Day has made no effort to obtain the consent of Gould or Pechiney, nor did it ever attempt to notify them

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79. See *Teradyne, Inc. v. Hewlett-Packard Co.*, 20 U.S.P.Q.2d (BNA) 1143, 1991 WestLaw 239940, U.S. Dist. LEXIS 8363 (N.D.Cal. 1991). *Teradyne* disqualified the law firm, looked carefully at the facts, and was impressed that counsel for the subsidiary was hired by and supervised by the legal department of the parent corporation.

80. *Pennwalt Corp. v. Plough, Inc.*, 85 F.R.D. 264 (D.Del. 1980).

81. 85 F.R.D. at 272.

82. 739 F.Supp. 1121 (N.D. Ohio, 1990).

of this conflict of interest."<sup>83</sup> But the court still refused disqualification as a remedy because —

*First*, there has been no demonstration that Pechiney has been prejudiced in any way by Jones, Day's representation of Gould. Confidential Pechiney information has not passed to Gould as a result of Jones, Day's representation of IGT, which is unrelated to the instant case. *Second*, disqualifying Jones, Day from representing Gould would not only cost Gould a great deal of time and money, in retaining new counsel, it would significantly delay the progress of this case. . . . *Finally*, the conflict was created by Pechiney's acquisition of IGT several years after the instant case was commenced, not by any affirmative act of Jones, Day. In short, *the integrity of the judicial process in this case has not been threatened by the conflict.*<sup>84</sup>

This test, whether the alleged conflict has threatened "the integrity of the judicial process," appears to be a strict one, suggesting that there should be very few parent/subsidiary cases where disqualification is an appropriate remedy. An example where the integrity of the judicial process would occur is the situation where the lawyer, while representing Corporation A<sub>1</sub>, learned client secrets that would be relevant in the case against Corporation A<sub>2</sub>. In that case, the representation would taint the judicial process because the lawyer learned relevant confidences that would be used to her advantage without the consent of Corporation A<sub>1</sub>.<sup>85</sup>

#### IV. CONCLUSION

Although the sister corporation issue is an important one, only recently have law firms and clients begun to appreciate its significance. The new ABA Formal Opinion will serve to highlight this issue and may lead to a revision in the ethics rules as lawyers and clients search for more definite guidelines.<sup>86</sup>

Florida is, thus far, the only jurisdiction to deal with this issue explicitly in its Rules of Professional Conduct. It provides that there is no *per se* disqualification and, like this article, it attempts to offer rela-

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83. 738 F.Supp. at 1126.

84. 738 F.Supp. at 1126-27." (emphasis added).

85. Westinghouse Electric Co. v. Kerr-McGee Corp., 580 F.2d 1311, 1321 (7th Cir. 1978), *cert denied*, 439 U.S. 955 (1978).

86. Apex Oil Co. v. Wickland Oil Co., 1995 U.S. Dist. LEXIS 6398 (E.D.Cal. 1995), decided after the ABA promulgated Formal Opinion 95-390 (Jan. 25, 1995), rejects its reasoning in favor of a much more specific, and narrow, approach. The court held that a parent and subsidiary would be considered the same for purpose of the conflict of interest rules only if the two entities were true alter egos.

tively concrete guidelines for both lawyers and clients.<sup>87</sup> Washington, D.C. is considering new Comments to its Rule 1.13 that are considerably more elaborate and comprehensive than Florida's efforts. These proposed Comments, like the Florida rule, also rejects a *per se* disqualification rule.<sup>88</sup>

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87. Its Comment provides:

*Representing Related Organizations*

Consistent with the principle expressed in paragraph (a) of this rule, an attorney or law firm who represents or has represented a corporation (or other organization) ordinarily is not presumed to also represent, solely by virtue of representing or having represented the client, or organization (such as a corporate parent or subsidiary) that is affiliated with the client. There are exceptions to this general proposition, such as, for example, when an affiliate actually is the alter ego of the organizational client or when the client has revealed confidential information to an attorney with the reasonable expectation that the information would not be used adversely to the client's affiliate(s). Absent such an exception, an attorney or law firm is not ethically precluded from undertaking representation adverse to affiliates of an existing or former client.

Comment to Florida Rule 4-1.13, effective January 1, 1992.

88. Proposed Comments 13 through 18 to Rule 1.13, titled "Organizational Clients," are now pending before the District of Columbia Court of Appeals. The proposed Comments provide: Organization Clients

[13] As is provided in Rule 1.13, the lawyer who represents a corporation, partnership, trade association or other organization-type client is deemed to represent that specific entity, and not its shareholders, owners, partners, members or "other constituents." Thus, for purposes of interpreting this Rule, the specific entity represented by the lawyer is the "client." Ordinarily that client's affiliates (parents and subsidiaries), other stockholders and owners, partners, members, etc., are not considered to be clients of the lawyer. Generally, the lawyer for a corporation is not prohibited by legal ethics principles from representing the corporation in a matter in which the corporation's stockholders or other constituents are adverse to the corporation. See D.C. Bar Legal Ethics Committee Opinion No. 216. A fortiori, and consistent with the principle reflected in Rule 1.13, the lawyer for an organization normally should not be precluded from representing an unrelated client whose interests are adverse to the interests of an affiliate (e.g., parent or subsidiary), stockholders and owners, partners, members, etc., of that organization in a matter that is separate from and not substantially related to the matter on which the lawyer represents the organization.

[14] However, there may be cases in which a lawyer is deemed to represent a constituent of an organization client. Such de facto representation has been found where a lawyer has received confidences from a constituent during the course of representing an organization client in circumstances in which the constituent reasonably believed that the lawyer was acting as the constituent's lawyer as well as the lawyer for the organization client. See generally ABA Formal Opinion 92-365. In general, representation may be implied where on the facts there is a reasonable belief by the constituent that there is individual as well as collective representation. *Id.* The propriety of representation adverse to an affiliate or constituent of the organization client, therefore, must first be tested by determining whether a constituent is in fact a client of the lawyer. If it is, representation adverse to the constituent requires compliance with Rule 1.7. See ABA Opinion 92-365, *supra*. The propriety of representation must also be tested by reference to the lawyer's obligation under Rule 1.6 to preserve confidences and secrets and to the obligations imposed by paragraphs (b)(2) through (b)(4) of this Rule. Thus, absent consent under Rule 1.7(c), such adverse representation ordinarily would be improper if:



(a) the adverse matter is the same as, or substantially related to, the matter on which the lawyer represents the organization client,

(b) during the course of representation of the organization client the lawyer has in fact acquired confidences or secrets (as defined in Rule 1.6(b)) of the organization client or an affiliate or constituent that could be used to the disadvantage of any of the organization client or its affiliate or constituents, or

(c) such representation seeks a result that is likely to have a material adverse effect on the financial condition of the organization client.

[15] In addition, the propriety of representation adverse to an affiliate or constituent of the organization client must be tested by attempting to determine whether the adverse party is in substance the "alter ego" of the organization client. The alter ego case is one in which there is likely to be a reasonable expectation by the constituents or affiliates of an organization that each has an individual as well as a collective client-lawyer relationship with the lawyer, a likelihood that a result adverse to the constituent would also be adverse to the existing organization client, and a risk that both the new and the old representation would be so adversely affected that the conflict would not be "consentable." Although the alter ego criterion necessarily involves some imprecision, it may be usefully applied in a parent-subsidiary context, for example, by analyzing the following relevant factors: whether (i) the parent directly or indirectly owns all or substantially all of the voting stock of the subsidiary, (ii) the two companies have common directors, officers, office premises, or business activities, or (iii) a single legal department retains, supervises and pays outside lawyers for both the parent and the subsidiary. If all or most of those factors are present, for conflict of interest purposes those two entities normally would be considered alter egos of one another and the lawyer for one of them should refrain from engaging in representation adverse to the other, even on a matter where clauses (a), (b) and (c) of the preceding paragraph [14] are not applicable. Similarly, if the organization client is a corporation that is wholly owned by a single individual, in most cases for purposes of applying this Rule, that client should be deemed to be the alter ego of its sole stockholder. Therefore, the corporation's lawyer should refrain from engaging in representation adverse to the sole stockholder, even on a matter where clauses (a), (b) and (c) of the preceding paragraph [14] are not applicable.

[16] If representation otherwise appropriate under the preceding paragraphs seeks a result that is likely ultimately to have a material adverse effect on the financial condition of the organization client, such representation is prohibited by Rule 1.7(b)(3). If the likely adverse effect on the financial condition of the organization client is not material, such representation is not prohibited by Rule 1.7(b)(3). Obviously, however, a lawyer should exercise restraint and sensitivity in determining whether to undertake such representation in a case of that type, particularly if the organization client does not realistically have the option to discharge the lawyer as counsel to the organization client.

[17] The provisions of paragraphs [13] through [16] are subject to any contrary agreement or other understanding between the client and the lawyer. In particular, the client has the right by means of the original engagement letter or otherwise to restrict the lawyer from engaging in representations otherwise permissible under the foregoing guidelines. If the lawyer agrees to such restrictions in order to obtain or keep the client's business, any such agreement between client and lawyer will take precedence over these guidelines. Conversely, an organization client, in order to obtain the lawyer's services, may in the original engagement letter or otherwise give consent to the lawyer in advance to engage in representations adverse to an affiliate, owner of other constituent of the client not otherwise permissible under the foregoing guidelines so long as the requirements of Rule 1.7(c) can be met.

[18] In any event, in all cases referred to above, the lawyer must carefully consider whether Rule 1.7(b)(2) or Rule 1.7(b)(4) requires consent from the second client whom the

There should not be a *per se* rule that assumes — for purposes of conflicts of interest — that the corporate veil should always be pierced. The lack of a *per se* disqualification rule does not mean that a corporate family would be unable to impose such a rule. The law firm and client, in the initial engagement letter, could always agree to treat some or all members of the corporate family as a single entity, or as separate entities. In light of the problems this article has discussed, lawyers and clients should try to foresee and solve these problems before they occur. If a law firm's decision to represent a particular corporation means that it must forego the opportunity to represent a whole host of other clients, the law firm should be told, at the time of retention, that it is making a decision that will impose heavy opportunity costs. Clients, as well, should think through whether it is worthwhile to impose this opportunity cost on the law firm.

Whether or not there is such an agreement, a law firm should not undertake a representation adverse to a corporation that is affiliated with a corporate client of the law firm if the adverse matter is the same as, or substantially related to, the matter on which the lawyer represents the client entity. The reason for this restriction is that clients can decide to waive, in advance, the lawyer's duty of loyalty, but courts will look with suspicion on a waiver, *in advance*, of the lawyer's duty to preserve confidences.<sup>89</sup> If the adverse matter is the same or substantially related to the matter on which the law firm presently represents the client entity, or if the law firm has learned confidences from the corporate client that are relevant to the case brought against the affiliate of the corporate client, the obligation to preserve the confidences<sup>90</sup> owed to the corporate client preclude the representation.

In the absence of an agreement governing the corporate affiliate issue, the law firm should not be adverse to the corporate affiliate of a client if the affiliate is the alter ego of the corporate entity. As discussed above, this alter ego theory has various permutations. If there really is an alter ego, if it is appropriate to pierce the corporate veil for the purposes of ethics, then the law firm should also refuse to undertake the representation.

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lawyer proposes to represent adverse to an affiliate, owner or other constituent of the first client.

89. See, ABA Formal Opinion 93-372, *Waivers of Future Conflicts of Interest* (April 16, 1993) ("courts are very reluctant to conclude from a prospective waiver an agreement by the client to waive rights of confidentiality.").

90. See, ABA Model Rule 1.6.

If consent of the corporate client or the affiliate of the corporate client is unnecessary, or has been earlier secured in the original engagement letter, the law firm should still secure the knowledgeable consent of the client that it is representing adversely to the corporate affiliate. As ABA Formal Opinion 95-390 pointed out, even if there is no need for consent from the corporate client (because any adverseness is "indirect,"), and there is no need for consent from the corporation affiliated with that client (because the affiliate is not a client), there still is a need to secure consent from the party that the law firm is representing against the affiliated corporation. In the case of the tort plaintiff against KFC, the law firm may not need the consent of KFC, Taco Bell, or Pepsico, but the law firm must secure the knowledgeable consent of the tort plaintiff.<sup>91</sup> The law firm must also satisfy itself that it will not be adversely affected.<sup>92</sup>

Stricter rules than the ones outlined in this article will impose costs on both lawyers and clients. These costs are not needed to protect the legitimate expectations of corporate families. Vaguer rules will also impose costs, and these costs serve to penalize the more ethical lawyers, the ones who would steer clear of ethical problems.

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91. ABA Model Rule 1.7(b)(2).

92. ABA Model Rule 1.7(b)(1).