Perils of Joint Representation of Corporations and Corporate Employees

A new lawsuit names as defendants the company and the CEO. The suit, on its face, appears utterly without merit, but you have not fully investigated the matter. As general counsel, you must weigh the risks and benefits of hiring a single law firm to represent both the company and the CEO. One of the greatest risks of hiring only one law firm, you have heard, is the possibility that the firm will be required to withdraw from the representation of *both* the company and the CEO if the two clients' interests are later seen to be in conflict. What are the rules in this treacherous area? One court has now adopted the *Restatement* rule allowing a lawyer to drop the CEO, or other corporate employee, as an "accommodation" client while keeping the company. *In re Rite Aid Corp. Securities Litigation*.[1]

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One of the most vexing problems facing inside counsel is the decision whether to hire one law firm to represent both the company and its employees (typically executives) when individuals are named as defendants along with the company. There are obvious financial benefits from hiring only one firm as defense counsel. More importantly, corporate employees and executives often prefer to be represented by the company's lawyers because they believe that this situation conveys to the plaintiff a united front and implies that the company fully endorses the employees' conduct in the underlying matter. On the other hand, in-house counsel are sensitive to the risks that conflicts can develop between the interests of the corporation and the interests of corporate employees. If that conflict ethically requires that the law firm withdraw from the representation of both the company and the employee, then the result will be deeply disruptive to the corporation's defense. Withdrawal from the representation of both joint clients when a conflict develops is, in fact, the general rule required by Model Rules 1.7, 1.9, and 1.16, but the *Restatement (Third) of the Law Governing Lawyers* has given impetus to the notion of "accommodation" clients. Under the "accommodation" client concept, now endorsed in the *Rite Aid* case, a lawyer can under some circumstances withdraw from the representation of the corporate employee or executive as an accommodation client and continue representing the company.

Before considering the accommodation client rule, let us review some of the rules of ethics and privilege governing joint representation. A lawyer may not represent two or more clients who are "directly adverse" to each other unless "the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and . . . each client consents after consultation." Model Rule 1.7(a). Because direct adversity suggests such situations as opposing parties in litigation or in transactions, this rule generally will not be applicable to situations in which the inside counsel is realistically considering having one law firm jointly represent both the com-

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pany and its executives or employees. The applicable standard is more likely to be Model Rule 1.7(b), which applies in situations in which the representation of one client "may be materially limited by the lawyer's responsibilities to another client . . . ." The question is whether the lawyer's obligation to secure the best outcome for the company will be "materially limited" by the lawyer's obligation to secure the best outcome for the jointly represented executive. In those situations, as in the 1.7(a) direct adversity conflict, the lawyer cannot undertake the representation unless he or she "reasonably believes that the representation will not be adversely affected" and "the client consents after consultation." Before taking on a dual representation in corporate civil litigation, a lawyer must therefore first "reasonably believe"[2] that the corporation and the executive or employee will not be "adversely affected" by the dual representation, and the lawyer must obtain the clients' consent "after consultation," which requires explaining the risks to each client.[3] Assuming that the lawyer concludes that the clients will not be "adversely affected" and that the two clients "consent after consultation," the lawyer may ethically agree to represent both clients. The two clients are generally considered coequal joint clients of the lawyer.

Now that we have worked out the ethical rules, it is important to review the rules of attorney-client privilege. The traditional rule is that there are no confidences between jointly represented clients, and thus the lawyer in our illustration is free to provide to the company any information the lawyer receives from the executive or other employee and vice-versa.[4] Even this area has become murky, however, because at least three significant jurisdictions now have reached a contrary conclusion: a lawyer is not free to share information between joint clients without the disclosing client's consent.[5] For example, D.C. Ethics Opinion 296 holds that, if, in jointly representing a corporation and an employee, the corporate employee discloses to the lawyer information about the employee's illegal conduct, then the lawyer cannot provide the information to the corporation absent the employee's consent. If the employee does not consent, then the lawyer must resign from the representation of both the company and the employee. The solution to this problem, the D.C. Ethics Opinion advises, is to secure prior agreement that the lawyer is permitted to share confidences between the two clients.

Returning to our case in chief, what happens when the lawyer who agreed to jointly represent both the corporation and the corporate employee discovers that the two clients' interests are conflicting? This situation can occur, for example, when subsequent investigation or discovery reveals that the executive was dishonest, breached a duty to the corporation, violated the corporate code of conduct, or broke a federal or state law in a mistaken attempt to benefit the corporation. Can counsel drop the corporate executive and proceed with the company as the sole client? In cases in which the lawyer undertakes the representation of two clients, the general ethics rule precludes the lawyer from terminating his or her representation of one of the clients in favor of the other client, even when a conflict subsequently develops between the two clients.[6] This situation has become known as the "hot potato" rule, in recognition of a well-known ruling that "[a] firm may not drop a client like a hot potato, especially if it is in order to keep happy a far more lucrative client."[7] The unhappy result of the hot potato rule is that the lawyer must withdraw from the representation of both clients when a conflict between the two clients develops.

Although the hot potato rule remains the prevailing standard, there is some developing support for the rule that withdrawal from the representation of only one of two joint clients is permissible if the dropped client is an accommodation client. Following a rule that developed in the Second Circuit, the *Restatement* opines that a lawyer may, with the informed consent of each client, undertake the representation of one client "as an accommodation to the lawyer's regular client."[8] In the event that adverse interests subsequently develop between the clients, even if relating to the matter involved in the common representation, that preclude the lawyer from continuing to represent both clients, then the accommodation client may be deemed to have consented to the lawyer's continued representation of the regular client in the matter.[9] This approach is the one that the U.S. District Court for the Eastern District of Pennsylvania adopted in *Rite Aid*.

Rite Aid was a federal securities class action resulting from the corporation's disclosure of severe

financial problems. The defendants included the corporation and its CEO.[10] Based on in-house counsel's belief that both defendants shared an identity of interest because the allegations were, in his view,[11] without merit, one law firm was retained to represent both the corporation and the CEO in the litigation. With respect to the representation of the CEO, however, in-house counsel instructed the law firm not to speak directly with the CEO, but to work through in-house counsel. The law firm included in its engagement letter that, in the event that a conflict arose between the corporation and the CEO, the CEO would be required to retain separate counsel and outside counsel would continue to represent the corporation. Two other facts are important. First, the CEO never provided any confidential information to the law firm.[12] Second, at the same time that in-house counsel had engaged one law firm to represent both the corporation and the CEO as counsel of record, a separate law firm was hired to represent only the CEO.[13] A law firm that is hired to look out for the interests of an individual client in these circumstances but not enter an appearance in litigation or surface publicly until absolutely necessary is sometimes referred to as "shadow counsel." An investigative audit subsequently disclosed apparently serious breaches of fiduciary duty on the part of the CEO, which the CEO had concealed. The firm that had jointly represented both Rite Aid and the CEO then advised Rite Aid that it could no longer represent the CEO, who had recently resigned, and that the CEO must retain his own counsel in the litigation.[14]

Following a partial settlement of the litigation, which resolved securities claims against Rite Aid but did not release the former CEO, the former CEO moved for disqualification of Rite Aid's law firm on the basis that its continuing representation of Rite Aid with respect to the partial settlement violated Model Rule 1.9(a). Model Rule 1.9(a) prohibits a lawyer from representing a client (here, Rite Aid) in the same or a substantially related matter in which that person's interests are materially adverse to those of a former client (here, the former CEO). In denying the motion, the court found that the CEO was an accommodation client under the terms of the *Restatement*.[15] Its conclusion was based on his engagement of and his dealings with the law firm through in-house counsel and the corporation, which was the basis for a finding that the CEO had consented to outside counsel's continued representation of the corporation.[16] The court also relied on the Second Circuit's holding before the accommodation client theory of the *Restatement*, in which the appeals court had held that simultaneous representation did not require disqualification in cases in which it was clear that the nonmoving party (the corporation) was the primary client and that the moving party (the former CEO) was a secondary client that had no reason to believe that any information would be withheld from the nonmoving party.[17] Finally, the court held that the former CEO had waived his rights.[18]

The American Law Institute's *Restatement (Third) of the Law Governing Lawyer*s is a relatively newly minted authority, and *Rite Aid* appears to be the first reported decision that has addressed the application of the *Restatement's* accommodation client theory to situations involving the simultaneous representation of a corporate entity and its individual members.[19] Although the theory may, in the future, provide a solution for conflicts that subsequently unfold during the course of this type of representation, it may require an engagement letter that clearly identifies outside counsel's responsibilities in the event a conflict develops between the interests of the corporation and those of the individuals.[20] Other factors that may warrant the inference that the accommodated client understood and consented to such representation include the individual client's contact with the law firm solely through the corporation,[21] the fact that the law firm had represented Rite Aid as the regular or primary client for a long period of time before its representation of the corporate employee or officer, the limited duration and scope of the representation of the corporate officer, and the understanding that the law firm "was not expected to keep confidential from [the corporation] any information provided to the lawyer by [the corporate officer]"[22] Finally, two factors weighing against disqualification in *Rite Aid* were that the CEO had had his own lawyer throughout the case to protect his rights and that he had had not provided confidential information to the corporation's lawyers.

Even if the accommodation client theory gains increasing acceptance, it has unknown risks. For example, after the law firm has withdrawn from the

representation of the accommodation client, what use can the law firm make of any information provided to it by the accommodation client during the course of the representation? Although the application of the accommodation client theory implies that the accommodation client has consented to the disclosure or sharing of information with the regular client,[23] does this consent also entitle counsel to use the information against the client after withdrawal? Of course, one can argue that no lawyer can forget what he has already learned. The question is whether the lawyer will be prohibited from acting adversely in any way to the former client because of the lawyer's duty "to take no unfair advantage of the client by abusing knowledge or trust acquired by means of the representation."[24]

ALTHOUGH THERE MAY BE NO PRINCIPLED DISTINCTION BETWEEN CIVIL AND CRIMINAL LITIGATION FOR APPLICATION OF THIS RULE, THE FACT IS THAT THE LIKELIHOOD OF A CONFLICT DEVELOPING BETWEEN A CORPORATION AND A CORPORATE EMPLOYEE OR OFFICER IS, IN THE AUTHOR'S EXPERIENCE, FAR GREATER IN CRIMINAL CASES THAN IN CIVIL CASES.

Rite Aid and the accommodation client rule from the *Restatement* are at the cutting edge of the ethics/privilege jurisprudence involving jointly represented clients. There is no assurance that other courts will follow this lead, and the consequences of the traditional hot potato rule can be calamitous if it results in the withdrawal of the law firm from the representation of both clients. Thus, although corporate counsel should keep an eye on these and other similar developments, it would be a grave mistake to rely upon the accommodation client rule without full recognition of the risks it entails.

If the risks are too high, there is a worthy alternative. The primary law firm could represent only the corporation, and the corporate employee-defendants could be represented by a separate lawyer(s) paid for by the corporation under its indemnity obligations. If the individuals' lawyers are urged to avoid duplication of work and agree to operate under a joint defense agreement, then the ethical and privilege risks are much diminished, probably without a huge increase in cost to the corporation. Of course, this alternative is financially realistic only in large cases in which you would otherwise hire shadow counsel. And it has a cost: the corporate employees are not represented jointly by the corporation's outside law firm. Most employees and some executives readily accept this result. Many CEOs find it unacceptable for appearance purposes.

The foregoing discussion of the accommodation client rule has been exclusively in the context of civil litigation, and so it should be. Although there may be no principled distinction between civil and criminal litigation for application of this rule, the fact is that the likelihood of a conflict developing between a corporation and a corporate employee or officer is, in the author's experience, far greater in criminal cases than in civil cases. And the conflicts can become much sharper if the government offers the corporation a good deal if it abandons the corporate employee (or vice versa). Thus, the dynamics of criminal litigation make it far less attractive to use the accommodation client theory there than in civil litigation.

What are the practical lessons to be learned from this analysis?

- Until your jurisdiction has endorsed the accommodation client rule, caution dictates hiring separate counsel for individuals and minimizing duplication of work.
- Don't rely upon the accommodation client rule in cases in which there appears a significant likelihood of a conflict developing.
- Draft initial engagement letters with extreme care. Recite therein that the corporation is the primary client, that the law firm is entitled to advise the corporation of anything that the individual client tells counsel, and that, in the event of a conflict, the law firm will withdraw from the representation of the individual and continue representing the corporation and is free to use all information that it has previously gained from the individual for any purpose whatsoever. Devote whatever time and resources are necessary to explain to the individual employee the implications of these terms, including having the individual employee consult with separate

counsel, in order to satisfy the burden of "consent after consultation."

- If financially feasible, hire shadow counsel to monitor the litigation for individual defendants and not enter an appearance or otherwise surface until absolutely necessary.

NOTES

1. *In re* Rite Aid Corp. Sec. Litig., __ F. Supp. 2d__, 2001 WL 389341 (E.D. Pa. 2001).
2. The term "reasonably believes" as defined in the "Terminology" section of the Model Rules means that "the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable."
3. The term "consultation" as defined in the "Terminology" section of the Model Rules means "communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question."
4. Brennan's, Inc. v. Brennan's Restaurants, Inc., 590 F.2d 168 (5th Cir. 1979).
5. D.C. Ethics Op. No. 296; New York State Bar Op. No. 555; *see also* Ill. Adv. Op. 98-07.
6. *Under the Model Rules of Professional Conduct*, the obligation of a lawyer to withdraw when presented with a conflict during the representation of a single client is governed by Rule 1.7(a). In cases in which a lawyer represents more than one client on a matter and withdraws from representing one of the clients after a conflict between the clients has developed during the representation, the question of whether the lawyer may continue to represent the remaining client(s) is determined by Model Rule 1.9, governing representations adverse to a former client. Model Rule 1.7, cmt. 2; *see also Restatement (Third) of the Law Governing Lawyers*, § 132, cmt. c (noting that the existence of grounds for mandatory or permissive withdrawal may be sufficient to render the representation of one client "former" under the former-client conflict rules of § 132, but only if the lawyer's primary motivation is not the desire to represent the other client).
7. Picker Int'l, Inc. v. Varian Assocs., Inc., 670 F. Supp. 1363, 1365 (N.D. Ohio 1987), *aff'd*, 869 F.2d 578 (6th Cir. 1989). *See also* Harte Biltmore Ltd. v. First Pennsylvania Bank, 655 F. Supp. 419 (S.D. Fla. 1987).
8. *Restatement (Third) of the Law Governing Lawyers*, § 32, cmt. i.
9. *Id*. (further providing that the lawyer bears the burden of showing that circumstances exist warranting the inference that the accommodation client had understood the relationship and had impliedly consented to the arrangement).
10. The chief financial officer and the president subsequently became clients of outside counsel in this matter under the same terms as the original representation of the corporation and the CEO. In re Rite Aid Corp. Sec. Litig., 2001 WL 389341, at *2.
11. In house counsel's view was based on the CEO's representation that the claims were meritless. *Id*. at *6.
12. *Id*. at *3.
13. *Id*. at *2.
14. *Id*. at *3.
15. *Restatement (Third) of the Law Governing Lawyers*, § 132, cmt. i.
16. *In re* Rite Aid Corp. Sec. Litig., 2001 WL 389341, at *8. The court also found that, aside from the accommodation client reasoning of the *Restatement*, the CEO had effectively consented to the continued representation of the corporation because the engagement letter "could not have been clearer with respect to the relationship between [outside counsel's] representation of Rite Aid and its representation of [the CEO]." *Id*.
17. *Id*. at *5–*6 (discussing Allegaert v. Perot, 565 F.2d 246 (2d Cir. 1977), and Kempner v. Oppenheimer & Co., 662 F. Supp. 1271 (S.D.N.Y. 1987)).
18. *Id*. at *9-*10.
19. In Universal City Studios Inc. v. Reimerdes, 98 F. Supp. 2d 449 (S.D.N.Y. 2000), the court rejected the law firm's assertion that the plaintiff, a former client, was an accommodation client whom the firm could unilaterally drop in favor of another client whom the firm represented in an unrelated action against the plaintiff. The court found that the firm's decision to undertake the representation of the other client was improper at the outset because of the adverse interests. The court also found that the firm's conclusion that the plaintiff was an accommodation client was based on factual assumptions that "are demonstrably wrong . . . unproved, or are unwarranted inferences drawn from assertions" made by the firm. *Id*. at 454.
20. In *Rite Aid*, the court stated that counsel's letter "made it pellucid" that the firm would, in the case of a conflict between the corporation and its CEO, cease its representation of the CEO but continue its representation of the corporation. Although the CEO contended that he did not see the letter nor agree to this provision, the court held that the CEO was constructively on notice of the letter's contents because it was "his decision to engage counsel through Rite Aid." 2001 WL 389341, at *8.
21. *Id*.
22. *Restatement (Third) of the Law Governing Lawyers*, § 132, cmt. i.
23. *See In re* Rite Aid Corp. Sec. Litig., 2001 WL 389341, at *5–*6 (discussing pre-*Restatement* cases applying primary client theory, wherein courts rejected the contention that counsel had breached the duty of confidentiality under Canon 4 because the secondary client had had no reason to believe at the outset of the representation that any information would be withheld from the primary client).
24. *Restatement (Third) of the Law Governing Lawyers*, § 33(d).