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Corporate Affiliate Conflicts of Interest

GSI Commerce Solutions v. BabyCenter, L.L.C., 2010 U.S. App. LEXIS 17182 (2nd Cir. 2010)

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On August 18, 2010 the United States Court of Appeals for the Second Circuit addressed the issue of corporate affiliate conflicts of interest. This is an issue that frequently challenges lawyers considering whether they can represent a client who is adverse to a corporate affiliate of another client that they or their firms represent. In a unanimous opinion written by Senior Circuit Judge Ralph Winter, the Second Circuit has provided a useful analysis of the issue. The opinion affirmed *GSI Commerce Solutions, Inc. v. BabyCenter, L.L.C.*, 644 F. Supp. 2d 333 (S.D.N.Y. 2009) (Rakoff, J.), in which a 500 person firm, Blank Rome, LLP, headquartered in Philadelphia, was disqualified from the representation of a client (GSI Commerce Solutions, Inc.) adverse to a wholly owned subsidiary (BabyCenter, L.L.C.) of another client (Johnson & Johnson) represented by the firm.

Significantly, each of the three circuit judges on the panel (Winter, Raggi and Livingston), and the district judge who initially decided the disqualification motion, had experience in large, multi-office firms at some point in their careers before they became members of the federal judiciary. While the issue is one that regularly confronts practitioners in such environments and in-house counsel, it is also one that increasingly confronts all lawyers who represent business interests with affiliates or joint ventures. *GSI* arises out of a big firm/corporate litigation context. Its lessons, however, are useful across the board.

The district court disqualified Blank Rome, and the Second Circuit affirmed, on the basis that the doctrine forbidding concurrent representation without consent codified in ABA Model Rule 1.7 (*see* KRPC 1.7) applied because the relationship between BabyCenter and J&J, which the law firm represented in other matters, was so close that the two were essentially one client for disqualification purposes.

BACKGROUND

The Attorney-Client Relationship

In 2004 Blank Rome entered into a client engagement with Johnson & Johnson ("J&J") for compliance and privacy matters involving J&J and its affiliates in connection with a European Union Data Protection Directive—an issue completely unrelated to the matter ultimately in dispute. The client engagement letter contained a provision waiving certain conflicts of interest relating to Blank Rome's ongoing representation of another unrelated client in a specific patent matter adverse to a J&J corporate affiliate. Subsequently, in 2005 Blank Rome returned to J&J and requested another waiver to which J&J agreed, amending the terms of the 2004 engagement letter. This waiver was for Blank Rome's representation of unrelated generic drug manufacturers in patent-related matters.

Blank Rome advised J&J and its affiliates, including BabyCenter, on a number of privacy-related issues.

Importantly, at no time did Blank Rome ever advise J&J with respect to the central issue in its dispute with GSI, an E-Commerce Services Agreement between GSI and BabyCenter. Nor did Blank Rome ever receive confidential information from J&J or BabyCenter relevant to the E-Commerce Services Agreement during its representation of J&J. Notwithstanding the consents obtained for the specified conflicts in other matters, Blank Rome never sought J&J's or BabyCenter's consent to waive any conflicts between Blank Rome's ultimate representation of GSI and its ongoing representation of J&J.

The Relationship Between J&J and BabyCenter.

BabyCenter, L.L.C. was a wholly owned subsidiary of J&J that operated as an on-line media center. It relied on J&J for almost all of its business services, including accounting, audit, cash management, employee benefits, finance, HR, IT, insurance, payroll and even travel services, even to the point of selecting outside counsel. It also relied on J&J's law department to provide legal services. Finally, J&J exercised a degree of management control over BabyCenter's business decisions.

The Relationship Between BabyCenter and GSI

GSI entered into an agreement with BabyCenter in 2006 where it agreed to run the day to day operations of BabyCenter's on-line store for young mothers in return for a percentage of revenues over a five year period. BabyCenter closed the on-line store prematurely, and GSI, pursuant to the contract, demanded mediation for its alleged lost profits.

Procedural Posture

The mediation demand was sent by a Blank Rome lawyer. Mediation was attempted, with Blank Rome representing GSI, and members of the J&J law department and another outside firm representing BabyCenter. The mediation was unsuccessful. Pursuant to the contract, GSI—again through Blank Rome—demanded arbitration. BabyCenter's lawyers informed GSI that it would not enter arbitration until Blank Rome ceased to represent GSI. GSI, again through Blank Rome, filed a motion to compel arbitration in the District Court. BabyCenter immediately moved to disqualify Blank Rome. The District Court disqualified Blank Rome on the basis that there was a concurrent conflict, and while it was consentable, Blank Rome had not obtained J&J's consent to the concurrent representation.

SECOND CIRCUIT'S ANALYSIS

The Second Circuit recognized that the public policy interest in a client's right freely to choose his counsel has to be balanced against the need to maintain the highest standards of the profession and the lawyer's duty of loyalty to a client. This was a case of first impression for the Second Circuit. Indeed, there appear to be no other federal circuits who have addressed the issue[1], although several federal district courts and several state appellate courts have done so. There are no reported cases in Kentucky. While acknowledging that it was not bound on a disqualification motion to follow the ABA Model Rules of Professional Conduct or the applicable state rules, the Second Circuit started its analysis by stating:

The ABA's Model Rules of Professional Conduct provide that a "lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary."ABA Model Rule of Prof'l Conduct 1.7 cmt. 34 (2006). This statement embodies what is often termed the "entity theory" of representation…However, an attorney may not accept representation adverse to a client affiliate if "circumstances are such that the affiliate should also be considered a client of the lawyer…"ABA Model Rule of Prof'l Conduct 1.7 cmt. 34 (2006). The ABA discussed this subject further in a 1995 Opinion Letter, concluding that "whether a lawyer represents a corporate affiliate of his client…depends not upon any clear cut per se rule but rather upon the particular circumstances." Am. Bar Ass'n Comm. On Prof'l. Ethics, Formal Opinion 95-390 (1995), reprinted in ABA/BNA Lawyers Manual on Prof'l. Conduct Ethics Opinions 1991-95, pp. 1001:262 (1996).

(The Kentucky Supreme Court adopted Model Rule 1.7, and Comment 34 on corporate affiliate conflicts effective July 15, 2009.)

The Second Circuit looked at a number of factors to apply a balancing test as to whether a corporate affiliate conflict exists. The factors it applied include:

1. The degree of operational commonality between affiliated entities; and
2. The extent to which one depends financially on the other.

With respect to the degree of operational commonality, the Court noted that other courts had considered:

- The extent to which entities rely on a common infrastructure;
- The extent to which the affiliated entities rely on or otherwise share common personnel such as managers, officers, and directors;
- The extent to which affiliated entities share responsibility for both the provision and management of legal services. "This focus on shared or dependent control over legal and management issues reflects the view that neither management nor in-house legal counsel should, without their consent, have to place their trust in outside counsel in one matter while opposing the same counsel in another." GSI at 7.

As to financial interdependence, the Court noted that several courts had considered:

- The extent to which an adverse outcome in the matter at issue would result in substantial and measurable loss to the client or its affiliate;
- The entities' ownership structure, with at least one lower court holding that an affiliate's status as a wholly-owned subsidiary of the client may suffice to establish a corporate affiliate conflict. Carlyle Towers Condo. *Ass'n, Inc. v. Crossland Sav.*, FSB, 944 F. Supp 789, 792 (S.D. N.Y. 1991).

The Second Circuit, however, rejected—as did the ABA-- the bright line of whether one entity is a wholly owned subsidiary of the other, "at least when the subsidiary is not otherwise operationally integrated with the parent company." GSI at 7, citing American Bar Ass'n Comm. On Prof'l. Ethics, Formal Opinion 95-390 at 1001:261-62." Instead, the Second Circuit, applying the facts to the commonality principles outlined above, found that the degree of operational commonality between BabyCenter and J&J was sufficiently strong to establish that the two entities should be treated as one single client for purposes of a disqualification motion. The Court also determined that there was a degree of overlap in management control between J&J and BabyCenter, thus indicating a degree of financial interdependence; the fact that BabyCenter was a wholly owned subsidiary appears to have been of lesser importance.

Additionally, the Court, while recognizing that there could be non-waivable corporate affiliate conflicts of interest, stated that in this instance J&J's consent to Blank Rome's representation of GSI would have been dispositive of the issue. GSI at 8, ftn. 2. Having apparently never been presented with a consent option by Blank Rome, and ultimately having chosen not to consent, J&J was on solid ground in seeking Blank Rome's disqualification.

In reaching its holding, the Court noted that the disqualification factors were not outweighed by those that would support the opposite conclusion. For example, the dispute between GSI and BabyCenter was completely unrelated to the matters upon which Blank Rome represented J&J. It was also completely unrelated to the discrete past representation where Blank Rome had advised BabyCenter. Additionally, J&J and BabyCenter never publicly presented themselves as a single legal entity; the contract specifically

prohibited GSI from mentioning that J&J had anything to do with BabyCenter. Most assuredly, J&J was not financially dependent on BabyCenter. Separate Blank Rome lawyers represented GSI in its dispute with BabyCenter and J&J. The opinion does not show what steps were taken to avoid a conflict. All we know is that J&J never consented to the representation. The Court simply found that the factors establishing operational commonality trumped these counter factors.

APPLICATION

As a practical matter, before ever having accepted the representation of GSI against BabyCenter in what clearly was a corporate affiliate concurrent conflict of interest, Blank Rome should have talked the issue through with not only J&J, but also with GSI. While hindsight is always 20/20, it seems that asking the appropriate questions on operational commonality and financial interdependence between J&J and BabyCenter could have avoided this debacle. A good place to start would have been a review of BabyCenter's and J&J's websites, and then entering into careful, probing conversations with the appropriate BabyCenter and J&J staff counsel.

The practical take away is to seek the corporate affiliate's consent if the concurrent representation is ethically permissible. If the consent of the appropriate corporate affiliate is not forthcoming, then the wisest course is simply not to accept the representation.

Assume that only after accepting the GSI representation did Blank Rome ultimately learn the extent of operational commonality and financial interdependence between J&J and BabyCenter: Could it have withdrawn as counsel for GSI? Perhaps it could have withdrawn under Model Rule 1.16 (KRPC 1.16) at an early stage before GSI would have been prejudiced. Here, however, Blank Rome took the representation all the way through mediation and then into Court when BabyCenter refused to arbitrate until Blank Rome withdrew. The Second Circuit also held that the mediation efforts of Blank Rome with BabyCenter and J&J lawyers did not constitute a waiver by J&J. While it is not stated in the opinion, one can only surmise that Blank Rome by that point would have been delighted to withdraw. My hunch is that GSI, having relied on Blank Rome for legal advice all the way through mediation and into a motion to compel arbitration, refused to permit the firm to withdraw.

Because Kentucky tracks Model Rule 1.7 and Comment 34, and in the absence of any definitive case law by a Kentucky appellate court or the Sixth Circuit, then the Kentucky practitioner should follow the strictures of GSI in analyzing corporate affiliate concurrent conflicts of interest.

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(1) The Sixth Circuit's leading case on disqualifications for conflict of interest is *Centra, Inc. v. Estrin*, 538 F.3d 402 (6th Cir. 2008). It obliquely addressed corporate affiliate conflicts of interest at page 413, ftn. 7 of the opinion, recognizing that in some instances they cannot be waived. *See* RESTATEMENT of The Law Governing Lawyers § 121 illus. 6 (2000). *See also Cliffs Sales Company v. American Steamship Company*, 2007 U.S. Dist. LEXIS 74342 (N.D. Ohio 2007) (Nugent, J.), in which the Court refused to disqualify Baker & Hostetler in a corporate affiliate concurrent conflict issue, and through his reasoning largely anticipates the Second Circuit's holding in *GSI*.