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

The Attorney-Client Privilege in the Parent-Subsidiary Context

BY JOHN K. VILLA

Your instincts were right because, as Rod Serling used to say on "You are entering the twilight zone." But there is a recent decision of the Third Circuit Court of Appeals that may provide you a roadmap on how to avoid the most serious problems lurking there. The complexity of the issues explored by the court of appeals, however, may have you wishing you had a GPS to lead you out of the TZ.

First, let's agree upon customary practice. It is common and entirely proper for in-house counsel to advise the entire corporate family—the parent corporation and its wholly-owned corporate subsidiaries.[1] As a general rule, the attorney-client privilege attaches to communications between in-house counsel and representatives of all corporate family members, and this arrangement does not constitute a disclosure that undermines the confidentiality which the privilege requires.[2] Each corporate entity is entitled to assert or waive the privilege as to that entity's communications if a third party seeks the production of privileged information of any corporate family member.[3] Of course if the subsidiary's management attempts to assert or waive the privilege in a manner that displeases the corporate parent, the parent corporation would presumably be empowered to replace the subsidiary's management. New management would then presumably follow the directions from headquarters.

But what happens to the privilege when the interests of the parent corporation and its affiliated companies diverge and ultimately become adverse? The most obvious example is when the parent corporation relinquishes control of an affiliated company because of the latter's insolvency and subsequent bankruptcy. Another example is a sale of a subsidiary. May the parent corporation assert the privilege against its former affiliate if a dispute ensues concerning the circumstances giving rise to the latter's insolvency and resulting bankruptcy or sale? Or, may the former affiliate unilaterally waive the privilege to the detriment of its former parent?

In a landmark decision, the United States Court of Appeals for the Third Circuit recently addressed these questions in *In re Teleglobe Communications Corp.*, by clarifying the scope and application of the attorney-client privilege in the context of the corporate family. Before focusing on the court's lengthy rulings and guidance, let's review the complex history of the Teleglobe decision.

Factual and Procedural Background

The underlying dispute involves a complaint in a bankruptcy proceeding brought against a second-tier parent corporation by the debtors: i.e. wholly-owned subsidiaries of what had been a wholly-owned subsidiary of the parent corporation. As related by the court, the complaint alleges that the parent corporation reneged on binding commitments to fund its wholly-owned subsidiary, and fraudulently or negligently induced its subsidiary and the second tier subs/debtors to continue to incur debt in reliance on these commitments, thereby harming the subsidiary, the second tier subs/debtors, and the debtors' creditors.[5] The complaint further alleges that the parent corporation breached its fiduciary duties to the second tier subs/debtors, since the parent corporation was the control-

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ling shareholder of both its subsidiary and the second tier subs/debtors while both entities were insolvent.[6]

In pursuit of its claims against the parent corporation, the second tier subs/debtors sought discovery of all documents pertaining to the parent corporation's decision to cease funding of its wholly-owned subsidiary. The debtors contended that in-house counsel represented all of the corporate family members in connection with the parent corporation's funding decision; alternatively, they argued that the documents were subject to discovery under a "conflicted fiduciary" exception to the attorney-client privilege.[7] A vastly overly-simplified explanation of the conflicted-fiduciary rule is that if a fiduciary has a conflict between its own interests and the interests of the supposed beneficiary, then the beneficiary may, upon a showing of "good cause," obtain attorney-client privileged communications between the fiduciary and the fiduciary's lawyers. It has most often been applied to allow shareholders to seek privileged communications between the corporation and its counsel.

A special master was appointed to consider these issues and conducted an *in camera* review of the documents,[8] ordering production of *all* documents listed on the privilege log, including documents produced by outside counsel hired to represent *only* the parent corporation.[9] He reasoned that the documents revealed that the parent corporation's in-house counsel broadly represented both the parent and its wholly-owned subsidiary relating to the latter's funding issues.[10] The special master further ordered production of documents prepared by outside counsel with respect to their representation of the *parent* corporation because the documents had been disclosed to in-house counsel who jointly represented the subsidiary.[11]

The district court affirmed the special master's decision.[12] It rejected the parent corporation's argument that there was no joint representation between the parent and the second tier sales subs/debtors. The district court held that such a finding was unnecessary: Only a finding of a joint representation between the parent and its wholly-owned subsidiary was necessary since the second tier subs/debtors were also parties to the joint representation as a matter of law.[13] This proved to be a pivotal issue on appeal.

Rulings

On interlocutory appeal to the Third Circuit, the appellate court vacated the order of the district court on the basis that the district court's factual findings did not support setting aside the parent corporation's privilege.[14] Applying Delaware law, the court of appeals remanded the case and ruled: (1) the parent corporation could be compelled to produce the documents, but *only if the district court finds that the parent corporation and the second tier subs/debtors were jointly represented by the same attorneys on a matter of common interest that is the subject-matter of the documents*; (2) the "conflicted fiduciary" exception may be applicable, depending upon a finding as to when the debtors became insolvent; and (3) a sanction precluding assertion of the privilege would be upheld if it is found that the parent corporation acted with the requisite intent in over-designating documents as privileged material.[15] Let's take a look at these rulings, albeit in a simplified form.

1. Joint Representation

In holding that the parent corporation could be compelled to produce the disputed documents to the debtors, the court of appeals ruled that, if the parties are found to have been coclients because jointly represented by *in-house* counsel,[16] the adverse-litigation exception would apply to preclude assertions of privilege by one party against the other party—unless there was an express agreement to the contrary.[17] It did not recognize that such an agreement was implied when dealing with a parent and subsidiary. Although the Delaware courts had not yet addressed this precise issue, the court predicted that they would concur.[18]

The court predicated its application of the adverse-litigation exception on a finding of joint representation by *in-house counsel* of the now adverse parties. While in-house counsel generally serves as counsel for both the parent corporation and affiliated companies,[19] a finding of joint representation with respect to a specific matter depends upon the scope of the representation actually undertaken by the lawyers.[20] Thus, the district court must on remand determine whether in-house counsel represented both corporate affiliates on the issue on which they were now adverse, and only to that extent would there be a waiver of privilege for in-

ACC's Amicus Influences Teleglobe/BCE Decision

ACC filed a dispositive amicus in the *Teleglobe* case, which was cited by Judge Ambrose in the opinion. To read the opinion, ACC's whitepaper on the subject of corporate counsel representing multiple members of the corporate family, and ACC's amicus, visit *www.acc.com/php/cms/index.php?id=84&fid=1240*. ACC fights for your client's privilege rights; information on our efforts, along with hundreds of resources to help you navigate this hot topic are available at *www.acc.com/php/cms/index.php?id=84*.

house counsel's work.[21] With respect to the documents prepared by outside counsel for the benefit of the parent but shared with in-house counsel, the Third Circuit ruled that if the parent law firm's documents were within the scope of in-house counsel's joint representation of the now adverse parties, they would be discoverable; but if outside the scope of the joint representation, they would not be discoverable.[22] Yes, it's confusing.

2. The "Conflicted Fiduciary" Exception

Under the doctrine set forth by the Fifth Circuit in *Garner v. Wolfinbarger*,[23] (known as the "*Garner* doctrine") shareholders in derivative actions charging fraud and breaches of fiduciary duties may be entitled to the production of privileged documents of the corporation upon a showing of good cause.[24] Lower Delaware courts have not only followed the *Garner* doctrine, but have also expanded its application to an action by minority shareholders alleging a breach of fiduciary duties by the controlling shareholder in connection with a merger transaction.[25] The *Teleglobe* court took this one step further, finding that the Delaware courts might similarly extend application of the *Garner* doctrine to the debtors' dispute with the parent corporation![26] As explained by the court,

> *[t]he Debtors argument here is similar: because [the parent corporation] controlled the Debtors while they were insolvent, it owed fiduciary duties to the Debtors of which their creditors (not the parent corporation) were beneficiaries . . . . [t]hus, in this dispute, in which the Debtors are asserting a breach of those duties for the benefit of their creditors, the Debtors should be able to put aside the privilege upon showing good cause.*[27]

The theory is that *once the subsidiary became insolvent*, its fiduciaries owed their duties to the sub's *creditors*, not the sub's shareholders. Thus, the creditors may be able to reach otherwise privileged communications between the parent and its lawyers. Insolvency is the key as to whether the creditors were the *de facto* beneficiaries of the fiduciary duties owed by the parent corporation so as to invoke this extension of the *Garner* doctrine. No finding on this issue was made in the court below so the *Teleglobe* court remanded the case for a determination as to when the debtors became insolvent.[28]

3. Preclusion of Privilege Assertion as Discovery Sanction

Finally, during the course of the special master's review of the parent corporation's privilege log, the parent corporation withdrew its claim of privilege on selective groups of documents on several occasions. Accordingly, the debtors contended that the district court's order should be upheld as a sanction for the parent's over-designation of privileged material.[29] In the absence of a sanction order, the court was unable to review the issue.[30] Recognizing, however, that preventing the assertion of the attorney-client privilege constitutes a legitimate sanction for discovery abuses where the conduct is willful or in bad faith, the court of appeals left the issue for the district court to determine on remand.[31]

Guidance for Corporate Counsel

Is there useful guidance here for corporate counsel representing corporate families? Yes. Is one of the rules to avoid representation of the parent and the wholly-owned subs? *No.*

- The first and most important rule is to be sensitive to the potential conflicts of interest between the parent and the subsidiaries. This comes most often from a potential sale of the subsidiary but can also result from a transaction where the subsidiary may voluntarily petition or be forced into bankruptcy.
- A good litmus test for possible conflict is if you feel uncomfortable discussing legal issues with management of a subsidiary or affiliate.

- Where you perceive a tension between the interests of corporate family members, consult counsel skilled in legal ethics to determine if the various affiliated companies may need separate counsel.
- If corporate affiliates need separate law firms, separate inside counsel should be assigned to monitor the firms.
- Secure an agreement that the parent controls the assertion, waiver, etc., of the privilege for all subsidiaries and affiliates for events and communications occurring during the time that the parent controls them despite subsequent sale, disposition, etc.

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NOTES

1. *See United States v. AT&T*, 86 F.R.D. 603, 616 (D. D.C. 1979) (recognizing that "[t]he cases clearly hold that a corporate "client" includes not only the corporation by whom the attorney is employed or retained, but also parent, subsidiary, and affiliate corporations."); *see also Amicus Curiae Brief of the Association of Corporate Counsel at 5-6, In re Teleglobe Communications Corp.*, __F.3d__, 2007 WL 2034156 (3d Cir. 2007) (No. 06-2915) ("It is normal practice for in-house lawyers to advise (often multiple) affiliated companies within the corporate group[.]").
2. *See In re Teleglobe Communications Corp.*, __F.3d__, 2007 WL 2034156, at *17 (3d Cir. 2007); see generally John K. Villa, *Corporate Counsel Guidelines*, § 1:22[C] (Thomson/West 2006).
3. *See Restatement (Third) of the Law Governing Lawyers*, § 75 cmt. e (2000).
4. *In re Teleglobe Communications Corp.*, __F.3d__, 2007 WL 2034156 (3d Cir. 2007).
5. *Id.*, 2007 WL 2034156, at *1-*2.
6. *Id.* at *2.
7. *Id.* at *3.
8. The special master initially conducted an *in camera* review of only some of the documents listed on the privilege log. However, after the parent corporation continued to withdraw its claim of privilege on selective groups of documents, the special master ordered a revision of the privilege log and conducted an in camera review of all of the documents. While the debtors claimed that the parent corporation's apparent over-designation of privileged documents warranted disclosure of all of the documents as a discovery sanction, the special master refused to impose disclosure as a sanction. *Id.* at *3-*4.
9. *Id.* at *4.
10. *Id.*
11. *Id.*
12. *Id.* at *5.
13. *Id.* (also concurring with the special master's finding that disclosure of outside counsel's documents to in-house counsel, who jointly represented both the parent and its subsidiary, rendered documents subject to discovery by the debtors).
14. *Id.* at *1.
15. *Id.* at *33.
16. The court distinguishes between the joint or co-client privilege, which applies in the corporate family context when in-house counsel undertakes representation of both the parent corporation and its affiliated companies, and the "common interest" or "community of interest" privilege, which applies when separate attorneys representing different clients with similar legal interests agree to share information pertaining to the common legal interest. *Id.* at *9-*12. The court notes that since "the [latter] privilege only applies when clients are represented by separate counsel . . . . [i]t is largely inapplicable to disputes like this one that revolve around corporate family members' use of common attorneys (namely, centralized in-house counsel). *Id.* at *13.
17. *Id.* at *14 (citing the *Restatement (Third) of the Law Governing Lawyers*, § 75 cmt. d).
18. *Id.* at *15.
19. *See* n. 2, supra.
20. As explained by the court, "a co-client relationship is limited by 'the extent of the legal matter of common interest.'" 2007 WL 2034156, at *10 (quoting from the *Restatement (Third) of the Law Governing Lawyers*, § 75 cmt. c).
21. *See id.* at *11 (discussing the circumstance relevant to determining the scope of a joint representation), and at *20 (noting that it is permissible for attorneys and clients to limit the scope of a joint representation).
22. *Id.* at *29.
23. 430 F.2d 1093 (5th Cir. 1970).
24. *Id.* at 1103-1104.
25. *In re Teleglobe Communications*, 2007 WL 2034156, at *30 (citing *Deutsch v. Cogan*, 580 A.2d 100 (Del. Ch. 1990).
26. *Id.*
27. *Id.*
28. *Id.* at 31.
29. *Id.* at 32.
30. *Id.*
31. *Id.*