Ethical Considerations in Business Transactions

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Select Sources of Ethical Standards

- ABA Model Rules of Professional Conduct
- Texas Disciplinary Rules of Professional Conduct
- Corporate Policies and Code of Conduct (including antitrust compliance programs)
- Securities laws
- Sarbanes-Oxley Act
- Other laws, rules and regulations
Ethical Standards

ABA Model Rules of Professional Conduct
“A lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice.”

Texas Disciplinary Rules of Professional Conduct
“A lawyer is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice. Lawyers, as guardians of the law, play a vital role in the preservation of society. The fulfillment of this role requires an understanding by the lawyers of their relationship with and function in our legal system. A consequent obligation of lawyers is to maintain the highest standards of ethical conduct.”
Ethics in M&A Transactions

- Confidentiality Agreement
- Letters of Intent
- Due Diligence
  - Communication of issues to boards of directors/management
  - Disclosure of problems that could impact the transaction
- Definitive Documentation
  - Negotiations
  - Drafting Issues
- Closing
- Post-Closing Relationships
A Lawyer’s Responsibilities - Scope

• Acting in a dual capacity
  – Cannot hide behind another title or a business role in the deal

• Managing the business people / bankers’ role and activities
  – Lawyers should ensure ethical behavior from other representatives of the company

• Ensuring the lawyer does not direct a client to conduct activity that the lawyer is prohibited from conducting
  – Statements made to other parties in negotiations
  – Engaging with counterparties
A Lawyer’s Responsibilities – Outside Counsel

• Advising outside counsel on ethical considerations and potential conflicts
  – Full information
  – Limitations of outside counsel’s process
• Identifying and resolving ethical problems
• Complying with in-house policies and procedures
• Outside counsel as former lawyer of adverse party
• Arm outside counsel with all the facts
• Dealing with ethical issues that could impact process/price
Communication Without Going Through Opposing Counsel’s Lawyer

ABA Model Rules of Professional Conduct
and
Texas Disciplinary Rules of Professional Conduct

“In representing a client, a lawyer shall not communicate about the subject matter of the representation with a person the lawyer knows to be represented in the matter, unless the lawyer has the consent of the other lawyer or is authorized by law to do so.”
Communications – Opposing Party

• Adversarial process
• Sophistication level of counterparty
• Unrepresented by counsel
  – ABA Rule 4.3 - The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.
  – Texas Rule 4.03 - When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer’s role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding.
• Ex parte discussion with a party represented by counsel
  – No indirect circumvention
  – Communicate with other counsel
Communications – Hypothetical

Lawyer is representing Rose Corp. in an acquisition of a division of Hayter Corp. The parties are agreed on most points, but have come to an impasse on whether Hayter Corp. should retain certain environmental liabilities of the division. Rose Corp.’s CEO wants to get the deal signed today because tomorrow morning he is taking the company jet to the Augusta National, where he will not be permitted to use his phone. Hayter's lawyer is in the hospital for a minor procedure, and is expected to be available in a few days.

Lawyer suggests that the Rose CEO give the Hayter CEO a call to hammer out the point.

Question:
Can Lawyer have the two CEOs negotiate the environmental issue?
Communications – Hypothetical

Answer:

If it would be an ethical violation for a lawyer to contact that party, the lawyer cannot circumvent the ethics rules by having a non-lawyer contact the third party.
Slowing the Conveyance of Information

ABA Model Rules of Professional Conduct
The ABA Model Rules allow a lawyer to slow the conveyance of information to the client, but nothing in the rules prevents the disclosure of the confidential information to the client.
Seller unintentionally mailed Buyer’s Lawyer a document intended for Seller’s Counsel regarding the status of a significant negotiation point between the parties. Buyer’s Lawyer takes swift action to make Seller aware of the misdirected communication and return the confidential documents. During the course of continued negotiations, Seller continued with their negotiating position even though the confidential information had been returned. With the perils of autocomplete on e-mail, we may have all been in this situation at some point.

**Question:**

Does Buyer’s Lawyer have an ethical obligation to refrain from disclosing the confidential information to Buyer?
Reading the Other Side’s Misdirected Communication - Hypothetical

**Answer:**

No, the negligence of the one side should not disable the effectiveness of advocacy of the lawyer who knows that there has been a misrepresentation made to her client.
Undisclosed Recording of Telephone Conversations

- **Federal Law**
  - Recording of a telephone conversation by a non-law enforcement individual is permitted with the consent of at least one party to the conversation.

- **Texas Law**
  - Lawyer is permitted to make undisclosed recording with opposing counsel if:
    - The recording attorney is a party to the conversation and consents;
    - The recording attorney does not engage in dishonesty or create the false impression that the conversation is not being recorded;
    - The recording attorney does not have an “unlawful purpose”;
    - The recording attorney is not otherwise prohibited by state or federal law from recording the conversation.
Confidentiality Agreements

• Purpose of confidentiality and non-disclosure agreements
• Good Faith/Bad Faith
  – “Fishing expeditions”
  – Process for destruction/return of confidential documentation
• How to handle violations of confidentiality agreements
  – Honest errors
  – Blatant violations
• Impact of violations on deal process and communication
• Enforcement and lack of policing of ongoing obligations
Auctions – Multiple Bidders

• Collusion among bidders?
  – Violations of confidentiality and non-disclosure agreements
  – Joint bids

• Failures to adhere to auction process guidelines
  – Overbidding to get into next round when there is no intention of keeping price static
Auctions – Unethical Sellers

• Messaging regarding other bidders
• Inflated pricing?
• Withholding crucial diligence information till after bid proposals submitted
  – Requiring full mark-ups of agreements when diligence is in initial stages
• Failure to hold bidders to auction process
  – Ethical bidder disadvantaged
  – Bidders incur costs/expenses without any real opportunity to participate in the process
Lawyer’s Role as Negotiator

ABA Model Rules of Professional Conduct

and

Texas Disciplinary Rules of Professional Conduct

“As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirement of honest dealings with others.”
Lawyer’s Role as Negotiator – Misrepresentations

• Puffery
  – “Puffery” (the exaggeration or overemphasis of certain facts in an attempt to gain a bargaining advantage) is permitted, but untrue statements are not

• False Statements
  – Lawyer must not “knowingly” make a false statement of material fact or law to a third person
    • The definition of “knowingly” requires actual knowledge of truth or falsity, as opposed to uncertainty or even suspicion of possible falsity
    • “Knowledge” can be inferred from circumstances
    • Federal sentencing guidelines provide that a person was willfully ignorant of an offense if the individual did not investigate the possible occurrence of unlawful conduct despite knowledge of circumstances that would lead a reasonable person to investigate whether unlawful conduct had occurred

• Omissions
  – Misrepresentations as a result of omissions are prohibited
  – Truthfulness vs. doing the other side’s diligence
Lawyer’s Role as Negotiator - Hypothetical

Lawyer representing Seller in an auction sale is negotiating with Bidder and knows that one other bidder is interested in the sale. No offers have been made to purchase Seller.

Question:
Can Lawyer say each of the following to Bidder?

- “There may be other bidders for Seller”
- “There are multiple other bidders for Seller”
- “Other offers are expected any day now”
- “Bidder is considering another offer”
Lawyer’s Role as Negotiator - Hypothetical

Answers:

– “There may be other bidders for Seller” – **YES**, this statement is permissible

– “There are multiple other bidders for Seller” - **NO**, this statement is NOT permissible

– “Other offers are expected any day now” - **YES**, this statement is permissible

– “Bidder is considering another offer” - **NO**, this statement is NOT permissible
Conflicts of Interest

ABA Model Rules of Professional Conduct
and
Texas Disciplinary Rules of Professional Conduct

“In the nature of law practice, conflicting responsibilities are encountered. Virtually all difficult ethical problems arise from conflict between a lawyer's responsibilities to clients, to the legal system and to the lawyer's own interest.”
Conflicts of Interest - ABA

ABA Rule 1.7(a) - A lawyer shall not represent a client if the representation involves a concurrent conflict of interest.

• Direct adversity
• Significant risk that representation will be materially limited
  – "Material limitations" conflicts can arise based on a lawyers' own interest in the company, the involvement of others with whom the lawyer has a personal relationship, or a myriad of other reasons
• Exceptions:
  – Reasonable belief by lawyer that they can provide competent and diligent representation
  – Not prohibited by law
  – Does not involve a claim by one client against another
  – Informed consent (by each) provided
Texas Rule 1.06 - A lawyer shall not represent (1) opposing parties to the same litigation, (2) parties in a substantially related matter or (3) parties in situations where such representation puts the lawyer adverse to another client or the lawyer’s own interests.

- Exceptions to (2) and (3):
  - Reasonable belief by lawyer that the representation of each client will not be materially affected
  - Each potentially affected client consents to such representation after full disclosure of the existence, nature, implications and possible adverse consequences of the common representation and the advantages involved, if any
Conflicts of Interest – Hypothetical

For four years, Lawyer served as General Counsel to Rose Corp., and in such capacity became familiar with a considerable amount of confidential information about Rose’s business and negotiation strategies. Six months ago, Lawyer became the General Counsel of Hayter Corp., which is currently in negotiations to acquire Rose Corp.

Question:
Can Lawyer represent Hayter Corp. in its acquisition of Rose Corp. where Rose Corp has not given its consent, even in the absence of specific evidence of actual misuse of Rose’s confidential information?
Answer:
Without first obtaining consent, Lawyer may not represent Hayter Corp if the matter is "substantially related" to Lawyer’s representation of Rose Corp. If Lawyer "could have obtained confidential information in the first representation that would have been relevant in the second," the matters are deemed to be "substantially related."

Lawyer should also consider whether her involvement in the Rose acquisition is best for her current client, Hayter Corp.
Conflicts of Interest - Hypothetical

A company is negotiating a merger in which it will be acquired, and one major issue is whether and at what levels the company's employees will vest in their incentive plan awards and retirement plans in connection with the transaction. Another major issue is the price to be paid in the acquisition to the company's shareholders. As such, the position taken with respect to employees may impact the price received by the company's shareholders.

**Question:**
An in-house lawyer has a significant amount of unvested incentive awards and retirement benefits that may be affected by the acquisition. Does she have a "material limitation" conflict in giving advice to the company with respect to vesting of benefits and on other matters affecting the purchase price?
Conflicts of Interest - Hypothetical

**Answer:**

Simply having benefits that may be affected by the acquisition does not, without more, create a "material limitation" conflict. However, if the lawyer lets concern over her employment and personal retirement plans (for example) weigh into her professional analysis of the course to take, then she has a conflict of interest.

The best course of action would be for the lawyer to advise that the purchase price to be paid to the shareholders be agreed prior to negotiating benefits for employees.
Conflicts of Interest - Identification of the Client

- Boss vs. client
- The transaction is not the client
- Corporation/entity vs. officers/shareholders
- Joint venture vs. members
- When management are also shareholders/owners
- Management of transaction counsel dealing with differing owners/shareholders (and their differing interests)
- Be cognizant of relationships and potential conflicts
- Selling subsidiaries and spin-offs with different management
- Restructurings and bankruptcies – board of directors vs. management vs. equity holders vs. other interest holders
Conflicts of Interest – Change of Control

• Management Issues
  – Outside counsel has pre-existing relationship with management
  – Management focusing on its incentive compensation/buyouts
  – Counsel instructed to accept more risk for better deal for management

• Stock Sales / Spin-offs
  – Majority stockholders vs minority stockholders
  – Outside counsel has relationship with significant shareholder and represents such shareholder in other transactions
  – Outside counsel focused on "retaining" subsidiary as a client post-transaction
  – Disputes between parties after the transaction

• Mergers
  – Joint representation of company and selling stockholders
  – Attorney-client representation passes to new owners of a business
  – Treatment of pre-transaction privileged information
Conflicts of Interest – Outside Counsel

- "Conflicting" messages given to outside counsel from in-house team
  - Business team vs. in-house legal team
    - Recognize differing objectives that could put in-house counsel opposite business team
  - Finalizing the transaction vs. setting precedent for future transactions
  - Short-term view vs. long term view
- Managing conflicting messages and working with outside counsel
Seller is selling a subsidiary, Fina LLC. Seller and its counsel know that Fina LLC has engaged in accounting fraud. Seller has not yet revised or made adjustments to the accounting statements of Fina LLC, but in the sale process discloses all information necessary to "uncover" Fina LLC's fraud by potential purchasers.

**Question:**
Is Seller aiding and abetting Fina LLC’s fraud?
Conflicts of Interest – Fraud Hypothetical

Answer:
If lawyer knows of fraud, ethical and legal obligations may require reporting
• Reckless disregard for the truth
• Duty of candor
• Fraud: Misrepresentation/concealment of material fact, reliance, and harm to the victim
• Successor liability
• Ongoing fraud
• Consider other legal issues the fraud raises (whistleblower, 10b-5, etc.)
• Consider risk created for client seller by not outright disclosing the fraud to the buyer
Privilege

• Does privilege apply to communications between target and buyer?
  – Common interest privilege rejected in the transactional context
  – Some courts have protected advice shared between merger parties, but only after a merger agreement has been signed or where there is a real threat of litigation related to the transaction

• Communications within the organization
Metadata

ABA Point of View

– Mining for metadata is ethically permissible
– Receiver of an inadvertent email is required to notify the sender, and is suggested (but is not required) to refrain from examining the materials or abide by the instruction of the sending lawyer

Texas Point of View

– Professional Ethics Committee For The State Bar Of Texas has not published an official opinion on the issue
– Texas courts have not explicitly adopted the standard set out in ABA

Lawyer’s Required Knowledge of Technology

– ABA Model rules and Texas rules both require requisite knowledge and skill to keep abreast of changes in the law and its practice, such as the benefits and risks associated with relevant technology
Up the Ladder Reporting

**ABA Model Rules of Professional Conduct**

If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization.
Up the Ladder Reporting

Sarbanes-Oxley Act Section 307

When an attorney becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney must report up to the chief legal counsel or chief executive officer of the organization.

- The SEC defines “material violations” as any material violation of federal securities laws, any material breach of fiduciary duty recognized by common law, or any “similar material violation”
- If the attorney does not receive an appropriate response, the attorney is required to report to the audit committee or the full board
Best Practices

• Transaction post-mortems
• Adoption of compliance programs
• Internal investigations in transactions with ethical issues
• Disclosure of risks to the board of directors
  – Issues to elevate and in-house counsel’s duty to elevate
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