Counsel Conflict Dilemmas in Mergers and Acquisitions

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COUNSEL CONFLICT DILEMMAS IN MERGERS AND ACQUISITIONS

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This article analyzes an important dilemma that raises liability and ethical concerns: Attorney conflicts of interest in the specialized setting of corporate acquisitions and mergers.¹ The ensuing discussion seeks to present a concrete analysis in conjunction with a recommended framework of attorney conflicts of interest in the publicly-held corporate acquisition context. First, the article will present a general overview of conflicts of interest for the corporate counsel. Second, these conflicts issues will be addressed in the corporate takeover setting, followed by an examination of such conflicts in parent-subsidiary mergers and leveraged buyouts in which incumbent management obtains a substantial equity interest in the entity. Third, the article will focus on counsel's conflicts of interest in the corporate acquisition context when advising committees of the board of directors.² Thereafter, the substantive impact of various procedural

* Radford Professor of Law, Southern Methodist University. I thank Mr. Christopher McGreal for his research assistance. Copyright 2005 © by Marc I. Steinberg. This article is derived from Marc I. Steinberg, Attorney Conflicts of Interest in Corporate Acquisitions, 39 Hastings L.J. 579 (1988). Copyright © 1988 by Hastings College of Law; reprinted with permission.

mechanisms will be explored.

I. OVERVIEW

From a general perspective, an attorney’s general conflict-of-interest responsibilities under the Model Rules of Professional Conduct (“Model Rules”) are governed by Rule 1.7. Under that rule, counsel must not represent a client if a disabling conflict of interest is present. When a concurrent conflict of interest exists, counsel may undertake (or continue) the representation if certain specified conditions are met. For example, when representation of multiple parties is involved in the transactional setting, dual representation is generally permitted, provided that (1) the lawyer discusses the concurrent conflict and its ramifications with each affected party, (2) counsel reasonably believes that competent and diligent


By the close of the [twentieth] century, about four-fifths of the states and the District of Columbia had adopted the Model Rules in large part, although with changes in certain substantive provisions, particularly the rules governing confidentiality. Other jurisdictions, including New York, retained the [Model] Code, sometimes with significant modification.

4. See MODEL RULES OF PROF’L CONDUCT R. 1.7 cmt. 28 (2004) (stating that “[w]hether a conflict is consentable depends on the circumstances [and that] [f]or example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other”).

5. Under Model Rule 1.7(a), a concurrent conflict of interest is present if either the attorney’s representation of a client will be directly adverse to a different client or a significant risk exists that the lawyer’s representation of one or more clients “will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.” Id. 1.7(a)(2).

6. See id. 1.7 cmts. 2, 4, 6–8, 18, 20.
representation will be provided to each such party, and (3) each affected party "gives informed consent, confirmed in writing."\footnote{7}

A number of other Model Rules address particular situations in which conflicts of interest may arise for the corporate practitioner. For example, Rule 1.9 addresses the issue of subsequent representation in a substantially related matter in which the prospective client's interest is materially adverse to the interest of a prior client.\footnote{8} Rule 1.11(b) focuses on the imputed disqualification of a law firm and the propriety of "screening" mechanisms when a former government attorney becomes associated with a firm that represents a client in a matter in which the former government attorney participated while serving with the government.\footnote{9} As a last example, Rule 1.13(g) deals with the propriety of counsel simultaneously representing the corporation and defendant corporate fiduciaries in a shareholders' derivative action.\footnote{10}

Neither the Model Rules nor other codified rules of conduct, however, expressly focus on counsel's ethical responsibilities in the corporate acquisition setting.\footnote{11} Given the relative frequency and the high financial stakes of these transactions, that omission is unfortunate. The dearth of judicial case law addressing this subject compounds the problem.\footnote{12}

\footnote{7. Id. 1.7(b). In order to engage in or continue the dual representation, such representation must not be prohibited by law. Id. 1.7(b)(2). In addition, the prospective multiple representations must not involve the bringing of a claim by a client against another client of the subject attorney in the identical litigation or in any other matter before a tribunal. Id. 1.7(b)(3). The term "informed consent" is defined in Rule 1.0(e) to denote "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." Id. 1.0(e).}

\footnote{8. Id. 1.9(a). In order to engage in such representation, counsel must procure the former client's informed consent, confirmed in writing. Id. See generally Richard W. Painter, Advance Waiver of Conflicts, 13 GEO. J. LEGAL ETHICS 289 (2000) (discussing the circumstances in which lawyers and clients should be able to contractually regulate future conflicts of interest).}


\footnote{10. MODEL RULES OF PROF'L CONDUCT R. 1.13(g); see, e.g., In re Oracle Sec. Litig., 829 F. Supp. 1176, 1189 (N.D. Cal. 1993) (relying on cases "requir[ing] corporations involved in derivative suits to retain counsel with no prior ties to the individual defendants or the corporation"); see also MODEL RULES OF PROF'L CONDUCT R. 1.13(g) cmt. 13–14.}

\footnote{11. See MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 7.}

Normative standards should be established to guide counsel’s conduct.

II. TAKEOVER BIDS

A. General Rule

Courts and commentators generally agree that, in the absence of a disabling conflict of interest (which includes, in this context, the perpetration of illegal conduct\(^\text{13}\)), the incumbent board of directors may be looked to as representing the corporate entity.\(^\text{14}\) Hence, in arm’s length corporate acquisitions, it is often presumed that because the board’s function is to act in the best interests of the corporation, there is no conflict between management and the shareholders.\(^\text{15}\) For example, in the hostile takeover setting, an accepted practice is for the board to evaluate the bid


with the guidance of the corporation’s counsel and investment bankers.\textsuperscript{16} Because the board is normally deemed disinterested in this context (particularly if reliance is placed on outside directors), no conflict of interest exists.\textsuperscript{17} As a result, when the challenge to incumbent management is mounted from outside the management group, current law suggests that separate counsel normally need not be retained to represent the interests of the various corporate constituencies.\textsuperscript{18}

B. Alternative Proposals for Reform

The general practice described above may be subject to criticism. In


When the [takeover] challenge to incumbent management comes from outside the management group, the role of the lawyer representing the organization must be to follow policies adopted by the organization, in accordance with the organization’s decisionmaking procedures. Persons authorized to act on behalf of the organization determine the organization's interest in responding to the challenge. \textit{Id.; see also supra} notes 14–15.

\textsuperscript{17} See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927–28 (Del. 2003); MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1126–27 (Del. 2003); \textit{Unitrin}, 651 A.2d at 1372–73; \textit{Paramount Commc’ns}, 571 A.2d at 1150; \textit{Moran}, 500 A.2d at 1356; Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); see also, MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 357–58 (3d ed. 2001) ("[A]t least under Delaware law, by retaining outside advisers (such as investment bankers and lawyers) and relying extensively on outside directors, the board, in all probability, will be able to rebut assertions that the defensive maneuvers implemented were primarily motivated by entrenchment purposes, i.e., a desire to retain control."); cf. Lucian A. Bebchuk & Alma Cohen, \textit{Firms’ Decisions Where to Incorporate}, 46 J.L. & ECON. 383, 419 (2003) (offering evidence that throughout the late 1990’s, companies’ takeover defenses significantly impacted the outcome of hostile bids); Lucian Bebchuk, Alma Cohen & Allen Ferrell, \textit{Does the Evidence Favor State Competition in Corporate Law?}, 90 CAL. L. REV. 1775, 1780 (2002) (stating "[m]anagers interested in preserving their jobs and private benefits of control will tend to favor restrictive takeover rules, whatever the costs to shareholders").


Central to the existence of this conflict is the fact that while Exxon and the [subject Reliance divisions] now share a corporate identity, that identity might be shattered as a result of the challenge mounted by the FTC to the acquisition of Reliance by Exxon. Should divestiture be ordered by the FTC, Exxon and the [subject Reliance divisions] will become competitors. This possibility, which would result directly from the proceeding at which Exxon seeks joint representation, gives rise to a fundamental conflict between Exxon and the [subject Reliance divisions]. \textit{Id.}
many takeovers the bulk of the shareholders, looking to the substantial premium normally paid by the acquirer, favor the successful consummation of the offer. The board of directors, on the other hand, may adopt defensive tactics with the principal objective of retaining control.\textsuperscript{19} Moreover, if the interests of other constituencies are to be considered, as permitted by several state statutes,\textsuperscript{20} those interests may diverge from the interests of the general shareholder populace. For example, corporate employees and communities with corporate operations in their locale justifiably may fear that approval of the acquisition by the subject corporation may result in unemployment and the loss of a major benefactor to community well-being.\textsuperscript{21}

1. \textbf{"Counsel for the Constituencies"}

Accordingly, an argument can be made that, in light of these conflicting views, separate counsel ("counsel for the constituencies") with no prior affiliation with the corporation or its fiduciaries should be retained to represent the various corporate constituencies. Counsel's principal role in this context would be to ensure that the views of the major constituencies from both a legal and policy perspective are brought to the board's attention. Although management may reject the positions asserted, the presence of separately retained independent counsel should help ensure that the various countervailing arguments will be communicated and explained to the board.

There are, however, at least two significant problems with such an approach. First, because the different corporate constituencies likely will

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take diverse positions in response to the takeover bid, there may be present a disabling conflict, precluding multiple representation. Second, the decision on whether to accept or oppose the prospective acquirer's offer remains within the discretion of the subject corporation's board of directors—the very body whose alleged inability to consider impartially the various interests prompted the appointment of "counsel for the constituencies." Consequently, the role of appointed counsel may well be superfluous, providing no tangible benefits.

Nonetheless, supporters of this proposal may argue that counsel for the constituencies need not advocate one constituency's position at the expense of others. Rather, counsel may serve solely as the "communicator" of the diverse views held by the constituencies to ensure that the board is cognizant of the various positions. Alternatively, it may be contended (although probably not convincingly, because the interests of the constituencies may be more antagonistic than mutual) that counsel's role may be likened to that of an "intermediary" under Rule 2.2 of the Model Rules of Professional Conduct. By engaging in this multiple representation as an intermediary, counsel would utilize his or her persuasive skills in an effort to convince management why certain actions should or should not be taken. Such dialogue might shed new light for the board in determining what response should be made to the takeover bid.

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22. See supra notes 17, 19 and accompanying text. It may be argued that counsel may act as solely the communicator of the diverse views held by the various constituencies. Counsel need not advocate one particular constituency's position over another. See infra notes 32–33 and accompanying text.

23. See MODEL RULES OF PROF'L CONDUCT R. 1.7 (2004); supra notes 3–11.

24. See MODEL RULES OF PROF'L CONDUCT R. 2.2 (1984). While the 2002 amendments to the Model Rules deleted Rule 2.2, a number of states continue to retain this provision (the lawyer as intermediary) in their ethical rules.

25. See id. 2.2 cmt.

26. Id. The comment to Rule 2.2 provides:

A lawyer acts as intermediary in seeking to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out financial reorganization of an enterprise in which two or more clients have an interest, arranging a property distribution in settlement of an estate or mediating a dispute between clients. The lawyer seeks to resolve potentially conflicting interests by developing the parties' mutual interests. The alternative can be that each party may have to obtain separate representation, with the possibility in some situations of incurring additional cost, complication or even litigation. Given these and other relevant factors, all the clients may prefer that the lawyer act as intermediary.

Id.
2. The "Consultative" Attorney

Even assuming that appointment of "counsel for the constituencies" is ill-advised from both a legal and practical standpoint, alternative approaches remain. One such approach is the appointment of the "consultative" attorney (or law firm) to render a "second opinion."27 During the past decade, from a general perspective, the consultative attorney mechanism to render a second opinion has been employed to a greater extent28 but nonetheless is currently utilized on a relatively infrequent basis.29 Under this approach, the consultative attorney, having no prior affiliation with the corporation or its fiduciaries, would be retained to evaluate the relevant circumstances and to render a second opinion regarding management's contemplated course of action.

Such a second opinion may be appropriate because, in most cases, the corporation's outside general counsel has been retained for a prolonged period of time.30 Perhaps as a result of the substantial legal fees earned and the long-term association with incumbent management, such counsel may find it troublesome to advise the corporate client with the requisite independence. Accordingly, the consultative attorney may play the meaningful function of providing legal advice and insights from a more


While legal advice is often extraordinarily useful, it is subject to problems, including the possibility that the attorney may erroneously evaluate the nature or strength of a case and the danger that the attorney's self-interest may impair the quality of his advice. At first glance, it appears that one way in which a client can respond to these problems is to obtain a second opinion from another lawyer.

28. See, e.g., Miriam P. Hechler, The Role of the Corporate Attorney Within the Takeover Context: Loyalties to Whom?, 21 DEL. J. CORP. L. 943, 972–73 (1996); see also Lawrence B. Pedowitz, Letter to the Editor, N.Y. L.J., Jan. 26, 1983, at 15 ("[W]hile I wholeheartedly endorse the suggestion that lawyers should regularly consult in order to improve the quality of their judgments, I believe it is incorrect to suggest that the 'second opinion' practice is not already extant in our profession."). See generally 17 C.F.R. §§ 205.2(b), 205.3(b)(6)(ii) (2004) (providing standards of professional conduct for attorneys representing an issuer and appearing and practicing before the SEC and providing in certain contexts that the procurement of a second opinion from independent counsel is deemed an appropriate response pursuant to the SEC's standards of professional conduct for attorneys).

29. See Hechler, supra note 28, at 969–74; John S. Martin, Jr., A Second Opinion, NAT’L L.J., Jan. 10, 1983, at 12 ("We agree with Mr. [former Judge] Sporkin and Mr. Steinberg that the concept [of a 'second opinion'] is a good one, and that attorneys should be open to its use in the future. It is a provocative and workable area within the legal profession."); Sporkin & Steinberg, supra note 27, at 1.

30. See Hechler, supra note 28, at 971.
neutral perspective.\textsuperscript{31}

There are important differences between the roles of counsel for the constituencies and the consultative attorney. First, unlike counsel for the constituencies, the consultative attorney represents the entity as a whole rather than the various constituencies. Accordingly, the multiple representation conflict-of-interest dilemma does not surface, at least not so explicitly, in this setting. Hence, like the outside general counsel, the consultative attorney initially may look to the incumbent board of directors as the proper representative of corporate interests.\textsuperscript{32} Second, the advice rendered by the consultative attorney may have a greater impact upon board conduct. Unlike counsel for the constituencies, the consultative attorney does not legally analyze the situation at issue from the perspectives of certain diverse interest groups, but rather from that of the corporation in its entirety. As a result, management may be in a more difficult position to reject advice with which it disagrees. Moreover, faced with the prospect that the consultative attorney is retained to proffer its opinion, the corporation's general outside counsel may be even more circumspect in formulating his or her advice.\textsuperscript{33}

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\item There are few events as important to a corporation's welfare as when a tender offer is made to its shareholders by another corporation, that is, an unfriendly takeover attempt. Normally, in these instances the client will retain specialized counsel in defending such takeover attempts. There are a number of decisions that arise during the course of a hostile battle for control that present disparate choices to the various interests comprising the corporate framework. Such points of decision are susceptible to having independent counsel render a second opinion to help ensure that the disparate interests are being duly represented.

\textit{Id.} The same "consultative" role may be played by an investment banker. \textit{See infra} notes 84--90 and accompanying text.

\item To ensure that the presence of consultative counsel has significant input rather than being merely superficial, such counsel, although initially looking to the incumbent board of directors as the proper representative of corporate interests, must maintain the requisite independence. \textit{See generally} MODEL RULES OF PROF'L CONDUCT R. 1.7 (2004) (providing the requisite independence necessary to avoid a conflict of interest).

\item This statement should not be construed as implying that retained counsel is necessarily biased. In this regard, however, the following assertion may be made:

Undoubtedly, it may be argued that, where a law firm composed of a fairly large number of attorneys serves as counsel, such second opinions are unnecessary. This is based on the premise that an attorney working within his or her law firm often consults with other attorneys in the firm before recommending action. Although this may well be true, the principal value of a second opinion is its independence. Although lawyers in the same firm are often free to express their independent judgments, nevertheless they
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Hence, the consultative attorney concept may have a beneficial impact on corporate accountability. Nonetheless, in either of the foregoing alternatives (i.e., counsel for the constituencies or the consultative attorney), the incumbent board determines the corporation's response to the takeover bid. Even if some members of the board do not have a material financial interest as evidenced by their lack of substantial stock ownership, the inside directors normally have significant stockholdings as well as an interest in maintaining their positions of power within the corporate structure. Any legitimate takeover bid, particularly one that is successful, also may signify to the financial world that the insiders are inadequate managers, an image that any reputable corporate executive loathes. To a certain extent, some courts recognize this claim of bias. When a majority of the board is comprised of outside directors who oppose the takeover bid, these courts are more receptive to invoke the broad protection of the business judgment rule.

3. "Counsel for the Committee"

Taking the above approaches a step (or perhaps several steps) further,

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34. "Inside" directors include those who also hold positions as executive officers of the corporation, or who are otherwise employed by the company, for example, as in-house corporate counsel.


37. "Outside" (or "independent") directors should be defined as those directors who do not have a material relationship with the corporation or its inside directors or executive officers. See Securities Exchange Act of 1934, Exchange Act Release No. 48,745, 81 SEC Docket 1586, 1586–89 (Nov. 4, 2003) (approving new corporate governance standards, including that the majority of directors of a subject board of directors be independent, for corporations listed on the New York Stock Exchange or the NASDAQ Stock Market); Joris M. Hogan, Corporate Governance Update: Changes in the Boardroom After Enron, 32 SEC. REG. L.J. 4, 12–14 (2004).

an argument can be made that a corporation's response to a takeover bid should be formulated by a committee comprised solely of outside directors. To help ensure detachment from the inside directors, the general outside counsel should play no significant role. Rather, separate counsel with no prior affiliation with the corporation or its fiduciaries should be retained for the purpose of advising the committee ("counsel for the committee"). Any communication that needs to be made by the general counsel should be made directly to the counsel for the committee and not to the outside directors. Given the outside directors' relative lack of pecuniary interest and the threat of monetary liability for breach of their fiduciary duties, it may be asserted that this proposal provides a viable alternative: the response to the takeover bid is delegated to the most disinterested members of the board who, with the advice proffered by counsel for the committee, will seek to represent the corporation's best interests.

This alternative, however, is not without its problems. Irrespective of whether one is an inside or outside director, the problem of structural bias


40. "Structural bias" may be defined as "inherent prejudice... resulting from the composition and character of the board of directors [and management]." Note, The Business Judgment Rule in Derivative Suits Against Directors, 65 CORNELL L. REV. 600, 601 n.14 (1980); see also id. at 619–26; cf. Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49, 53–54 (5th Cir. 1980) (recognizing the possibility of structural bias, the court held that, due to conflicts of interest, the board was incompetent to compromise the plaintiff shareholders' derivative claims); In re PSE & O S'holder Litig., 801 A.2d 295, 320 (N.J. 2002) (stating that "[d]irectors understandably are not likely to be enthusiastic about approving the prosecution of a shareholder's suit against members of management with whom the directors maintain an ongoing relationship"); Miller v. Register & Tribune Syndicate, 336 N.W.2d 709, 718 (Iowa 1983) (recognizing structural bias problem in refusing to dismiss derivative suit against corporate fiduciaries where members
remains. Outside directors may owe their retention on the board to the insiders. During their tenure, outside directors are likely to develop friendships with their colleagues, affecting their impartiality. Moreover, a number of the outside directors may come from the same background as the insiders (e.g., they may themselves be insiders of other corporations) and may have known the insiders long before they were requested to serve as directors. There is also a certain prestige of serving as a director of a reputable publicly-held company. A takeover bid may be viewed by outside directors as an insult to their business acumen, which should be swiftly rebuked. Hence, far from being assumed to be independent, outside directors are potentially biased.

4. The Preferable Approach—The "Consultative" Attorney

Under the framework adopted by several courts, a board of directors under the business judgment rule may fend off a takeover bid in order to maintain the enterprise as an ongoing, viable entity. With that principle in

41. Hence, although not financially interested, such outside directors may be "interested" in maintaining:

[Positions of power, prestige and prominence . . . . They are "interested" in defending against outside attack the management which they have, in fact, installed or maintained in power . . . . And they are "interested" in maintaining the public reputation of their own leadership and stewardship against the claims of "raiders" who say that they can do better.

Panter, 646 F.2d at 300-01.

42. See In re PSE & G S'holder Litig., 801 A.2d at 312 ([T]he Court is well aware of the questions now being raised in the broader marketplace about the objectivity and responsibility of corporate directors"); Steinberg, supra note 19, at 6-7 (“Incumbent management’s control of the proxy machinery and general informational processes . . . frequently results in undue directorial loyalty to management rather than the exercise of independent judgment.”) (footnotes omitted); see also Note, Judicial Defere, supra note 40, at 1898 (“Confronted by difficult issues of business policy and largely dependent upon management for information about these issues, [outside] directors are likely to believe that management’s views and judgments are worth adopting.”) (footnote omitted).


43. See Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 (Del. 2003); MM
focus, attention should turn to providing the means by which the board can more effectively represent the corporation's best interests. In the context of legal advice, the appointment of the "consultative" attorney to provide a "second opinion," although far from perfect, should be viewed as a preferable route.\footnote{44}

It should be recognized, however, that the consultative attorney (or consultative law firm) may itself have an inherent bias. "A number of major law firms today have the reputation of counseling subject corporations to ward off hostile bidders."\footnote{45} With each successful defense, the law firm's reputation is enhanced in the eyes of potential target management. Hence, it is to such a law firm's financial benefit to devise successful legal strategies for implementation by subject corporations.\footnote{46} Retention of such a law firm as separate counsel may be appropriate after an informed board acting in good faith determines to oppose a takeover bid, but it may be questioned whether retaining the firm prior to a bidder indicating interest serves the corporation's and shareholders' best interests. Given the realities of corporate practice, however, these firms will certainly continue to be separately retained prior to any acquirer overtures. On balance, this approach can be justified. The development of anti-takeover strategies with expert counsel's input is a valid planning arrangement. With such defensive measures in place, the board is more likely to defeat inadequate bids, rather than having to fend them off with insufficient ammunition. Moreover, the adoption of these measures, at least in theory, does not prevent the board

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\footnote{44}{See supra Part II.B.2.}
\footnote{45}{Marc I. Steinberg, \textit{Attorney Conflicts of Interest in Corporate Acquisitions}, 39 \textit{HASTINGS L.J.} 579, 592 (1988).}
\footnote{46}{See Hechler, supra note 28, at 973–75; Editorial, \textit{Life Tenure for Managers?}, \textit{WALL ST. J.}, Apr. 23, 1987, at 32, Col. 1 (In reaction to the Supreme Court's decision in \textit{CTS Corp. v. Dynamics Corp.}, 481 U.S. 69 (1987), upholding the constitutionality of the Indiana anti-takeover statute, the Journal opined: "Lawyer Marty Lipton, king of the entrenched-manager bar, is doing cartwheels.").}
from making a dispassionate assessment of the bid's merits. In this regard, however, separately retained counsel's role in devising and counseling the board's adoption of anti-takeover strategies should preclude it from being retained as consultative counsel.

Due to the presence of structural bias and the appearance of impropriety, a lawyer or firm qualified to serve as consultative attorney to render an impartial second opinion should have no prior association with the corporation or its fiduciaries and should be knowledgeable in the field of mergers and acquisitions. Attorneys affiliated with such a law firm generally will be highly qualified to advise in this consultative role. Nonetheless, such counsel, if retained by incumbent management, may give the appearance that they favor the incumbent board. To lessen that effect as much as practicable, the selection of the consultative attorney (or law firm) should be within the outside directors' purview. In this way, the corporation and its various constituencies benefit from procuring expert advice from counsel who has no prior affiliation with the corporation or its fiduciaries, thereby increasing the likelihood that the second opinion will be truly independent.

III. PARENT SQUEEZE-OUTS AND LEVERAGED BUYOUTS

The foregoing discussion presumed that the subject corporation's board of directors or a controlling shareholder did not have a material financial interest in the proposed transaction. Such a financial stake increases the potential for conflict. This section will consider two types of transactions where this problem exists: namely, first, squeeze-out mergers, in which the parent corporation eliminates the public shareholders of its subsidiary (or alternatively when a controlling shareholder of a corporation uses his or her power to take the enterprise private), and second, leveraged

47. It may be asserted that the consultative attorney should be required to have recently represented on a fairly equal basis both offeror and subject corporations in contested takeover bids. The frequency of representation between offerors and targets need not be precisely equal. Such representation, however, must be rendered during contested bids in order to be relevant in this context. By representing both bidders and targets in contested bids, counsel will be less likely to have a bias, albeit unconsciously, in favor of one side over the other. On the other hand, such a requirement may be too rigid. Regardless of whether counsel principally has represented targets or bidders in hostile battles, it may be argued that the requisite expertise and independence to render a second opinion is present.

buyouts, in which corporate management procures a substantial equity interest in the enterprise.

A. Controlling Shareholder Squeeze-Outs

With respect to squeeze-out mergers, it is clear that the parent corporation, as controlling shareholder, owes a fiduciary duty to the subsidiary's public shareholders. As interpreted by the Delaware Supreme Court, the parent corporation in long-form mergers must accord the minority entire fairness comprised of fair dealing and fair price. Disregard of those obligations may give rise to a shareholders' action premised on breach of fiduciary duty. Although a number of other states have relegated a minority shareholder to solely his or her appraisal rights based on claims of unfair treatment, that consequence does not alleviate counsel's conflict-of-interest dilemma. Counsel who represents both the parent and the subsidiary corporation in a squeeze-out situation will find it difficult to adequately represent the interests of minority shareholders. Even where the subsidiary has retained separate counsel, that counsel is faced with the dilemma that what is beneficial to the subsidiary’s controlling shareholder (i.e., the parent corporation) may unfortunately be detrimental to the minority.

From the perspective of corporate accountability, minority shareholders comprise an essential component of a parent-controlled

51. Weinberger, 457 A.2d at 712, 714.
52. See, e.g., MINN. STAT. ANN. § 302A.601 (West 2004); Steinberg v. Amplica, Inc., 729 P.2d 683, 690 (Cal. 1986); Yanow v. Teal Indus., Inc., 422 A.2d 311, 318 (Conn. 1979).
subsidiary. Additionally, the parent, over a period of time, has elected to reap the benefits of a public equity market for its subsidiary’s stock rather than taking the enterprise private. Consequently, the interests of the minority should be viewed as an integral aspect in ascertaining the limits of permissible corporate conduct. Because the interests of the parent corporation as controlling shareholder of the subsidiary often conflict with the best interests of the minority, a disabling conflict of interest should be presumed, thereby precluding the attorney from representing all affected parties.

Accordingly, the outside directors of the subsidiary should be designated as a duly authorized committee charged with the task of bargaining with the parent corporation to help ensure fair treatment for the minority. To effectuate that objective, the committee should retain an investment banker and counsel with no prior affiliation with either corporation or its inside directors. Although the problem of structural bias


When all or part of incumbent management seeks to obtain control of the organization, typically by restructuring ownership of and authority in the organization, a conflict of interest is presented between the individual interests of those members of management and the holders of ownership and authority. Because of their personal interests, those members of management ordinarily would not be appropriate agents to direct the work of a lawyer for the organization with respect to the takeover attempt. Whether a lawyer’s personal interests, for example, those based on longtime association with incumbent management, preclude the lawyer from representing the organization or the managers seeking control depends on whether the lawyer’s personal interests create a substantial risk of material and adverse effect on the representation.

Id.

58. See Tremont, 694 A.2d at 428; Kahn v. Lynch Commc’n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994); Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983). In the setting of a parent-subsidiary merger, bargaining principally will involve matters of fair value, namely price, although fair dealing also plays an integral role. See Weinberger, 457 A.2d at 709–10 n.7, 711–14.

59. To an increasing extent, this proposal is being advocated. See Tremont, 694 A.2d at 429; In re Digex, Inc. S’holders Litig., 789 A.2d 1176, 1207 (Del. Ch. 2000); 19 Sec. Reg. & L. Rep.
among directors is not resolved by this proposal, the impact of any such bias is likely to be alleviated by the retention of outside experts who hopefully will have the requisite independence. Although imperfect, the proposal provides a practical and more enlightened solution.

The standards set forth above arguably should apply equally when a controlling individual shareholder, by means of a forced transaction, such as a merger with an entity wholly owned by that shareholder and created for the single purpose of effectuating the transaction, takes the corporation private, thereby eliminating the minority. In such situations, for the reasons stated above, the outside directors of the corporation should be designated as a duly authorized committee to represent the interests of the minority. The committee should retain an investment banker and counsel who have no prior affiliation with the corporation or its inside directors. This scenario, however, manifests the potential of structural bias of the

(BNA) 175 (Jan. 30, 1987) (statement of Arthur Fleischer, Jr.); Geoffrey C. Hazard, Jr. & Edward B. Rock, A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel, 59 BUS. LAW. 1389, 1391–92 (2004); Roger Lowenstein, GAF Chairman Gets Approval for Buy-Out, WALL ST. J., Oct. 21, 1988, at A4; Gary Putka & Ralph E. Winter, BP Increases Bid for Standard Oil by $450 Million, WALL ST. J., Apr. 29, 1987, at 2 ("The new bid [by British Petroleum Co., which owns fifty-five percent of Standard Oil Co.] won the acceptance of seven outside Standard Oil directors who had sought better terms."). Note, however, that the investment banker and counsel selected by the outside directors often may have a prior affiliation with either of the corporations or subject fiduciaries, hence giving rise to the structural bias issue.

60. See supra notes 45–46 and accompanying text.
61. See Hazard & Rock, supra note 59, at 1391–92; Kaplan, supra note 21, at 52; Ronald D. Rotunda, Conflicts Problems When Representing Members of Corporate Families, 72 NOTRE DAME L. REV. 655, 678 (1997); Steinberg & Lindahl, supra note 48, at 406.

Under the present framework . . . few independent parties would thoroughly evaluate a company without a reasonable chance of successful purchase, except for the investment banker selected by management to render a fairness opinion. Generally, the minority interest cannot afford to hire its own investment banker. Therefore, to help effectuate the intent of the independent evaluation alternative, the outside directors of the subsidiary corporation should retain an investment banker who has no previous contacts with the parent or subsidiary corporation or with either corporation's management. Through the use of the fairness opinion relied on by minority shareholders, an independent investment banker who is free of the usual structural biases will help insure that the going private transaction is fair to the minority.

Id. (footnote omitted).
62. For explanatory material on triangular mergers and other corporate combinations, see STEINBERG, supra note 43, § 4.01[3].
63. See supra note 54.
64. See supra notes 49–61 and accompanying text.
outside directors in an individually dominated corporation (presuming there are outside directors on the board). As a result, the added procedural mechanisms, such as the appointment of separate counsel, may provide little substantive protection for the minority. Thus, the minority may be provided with more meaningful relief by a flexible interpretation of fiduciary duty obligations and of valuation in the appraisal proceeding.\textsuperscript{66} In any event, and particularly if separate counsel is not retained, the corporation’s general counsel should remain cognizant of the possible conflicting interests and should advise the board of directors to adhere to the fiduciary duties owed to the minority.\textsuperscript{67} Indeed, because the controlling shareholder(s) will financially benefit from the transaction, counsel should look solely to the disinterested members of the board to represent the enterprise.\textsuperscript{68}

B. Leveraged Buyouts

Leveraged buyouts in which public shareholders are cashed-out and corporate insiders obtain a substantial equity interest in the ongoing enterprise have long raised troublesome questions of conflicts of interest.\textsuperscript{69} In this situation, the insiders’ interests in procuring a bargain price are adverse to the public shareholders’ objective of maximizing their returns. Moreover, the concept of insiders enhancing their pecuniary interests through the use of borrowed funds collateralized with corporate assets and subject to repayment out of corporate revenues strikes some authorities as repugnant to public shareholder welfare.\textsuperscript{70}

\begin{itemize}
\item \textsuperscript{67} See MODEL RULES OF PROF’L CONDUCT R. 1.7 cmt. 10 (2004) ("The lawyer’s own interests should not be permitted to have an adverse effect on representation of a client.").
\item \textsuperscript{68} In short, this is likely an interested director’s transaction in which the participating director is disabled from exerting undue influence upon the corporation’s response to the transaction. See Ahmed Bulbulia & Arthur R. Pinto, Statutory Responses to Interested Directors’ Transactions: A Watering Down of Fiduciary Standards?, 53 NOTRE DAME LAW. 201, 227 (1977); Kenneth B. Davis, Jr., Approval by Disinterested Directors, 20 J. CORP. L. 215, 216 (1995); Harold Marsh, Jr., Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 BUS. LAW. 35, 42 (1966).
\item \textsuperscript{69} Thirty years ago, then SEC Commissioner Sommer opined: “The shareholder must no longer be a second class citizen. Once he is invited to feast and he pays his admission, those who own the tent must not be able to usher him out at the end of the second course with only the menu as his souvenir.” “Going Private”: A Lesson in Corporate Responsibility, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,010 (1974).
\item \textsuperscript{70} See Brudney & Chirelstein, supra note 49, at 1359; Deborah A. DeMott, Directors’
It thus should not be surprising that both the insiders and public shareholders should have separate counsel to represent their opposing interests.\textsuperscript{71} Because the insiders have a material financial stake in the transaction, they no longer can be looked to as representing the corporate entity.\textsuperscript{72} Hence, the role of the corporation's general counsel in this context may well be to help ensure that adequate disclosure is made (to the board of directors and shareholders) and to advise the directors of their fiduciary duties.\textsuperscript{73} Moreover, the disinterested directors should comprise a special committee and retain an outside law firm and an investment banker, both of whom have no prior affiliation with the corporation or the insiders.\textsuperscript{74} Such precautions increase the likelihood that the determination to authorize the buyout and the valuation reached will maximize shareholder value\textsuperscript{75} and be reasonably informed.\textsuperscript{76}

IV. SUBSTANTIVE EFFECT OF PROCEDURAL MECHANISMS

This article has suggested that, in the takeover bid context, special counsel, such as the "consultative" attorney, be retained by the outside directors to advise the board of directors and that, in certain other acquisition situations, a committee comprised of disinterested directors be advised by separate independent counsel. After receiving the advice of separately retained counsel and investment bankers, the board and pertinent

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\textsuperscript{71} See supra notes 49–61 and accompanying text.

\textsuperscript{72} See authorities cited supra notes 59, 68–70.

\textsuperscript{73} See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS: CONFLICTS OF INTEREST § 131 cmt. h (2000).

\textsuperscript{74} See supra note 65 and accompanying text.


\textsuperscript{76} See supra Parts II.B.2, II.B.4, and note 75 and accompanying text. The outside general counsel should be wary of representing both management and the issuer in this context. Such dual representation may result in waiver of the attorney-client privilege. See ARTHUR M. BORDEN & JOEL A. YUNIS, GOING PRIVATE § 9.01 (2002). Indeed, normally counsel should represent solely the entity. \textit{Id.}; see RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS: CONFLICTS OF INTEREST § 131 cmt. h.
committee(s) may better represent the germane interests at stake. This scenario raises the question whether procedural mechanisms provide any meaningful substantive protection to corporate and minority shareholder interests.77

The problem of directors’ structural bias has been discussed above and elaborated upon by courts and commentators.78 Moreover, the alleged bias of investment bankers in rendering fairness and other valuation opinions has been raised, but certainly not resolved.79 Attorney conflict-of-interest dilemmas also come into play in the corporate acquisition context. A law firm that annually derives hundreds of thousands, if not millions, of dollars in fees from a corporate client has a financial self-interest in counseling to maintain that entity as an ongoing, independent concern with the incumbent management intact.80 Successful consummation of a third-party takeover bid—whether by merger, tender offer, or otherwise—normally signifies that the third party’s law firm will be retained to represent the combined enterprise.81 Although a number of courts have refused to recognize this potential for conflict,82 such an approach ignores the realities of law firm

77. See Longstreth, Now Private Citizen, Calls for Reform in Leverage Buyouts, 16 Sec. Reg. & L. Rep. (BNA) 641 (Apr. 13, 1984); Longstreth says Federal, State Laws are not Assuring Fairness in Buyouts, 15 Sec. Reg. & L. Rep. (BNA) 1908–09 (Oct. 14, 1983) (noting former SEC Commissioner Longstreth’s criticisms of certain procedural mechanisms, such as investment bankers’ fairness opinions, as providing no substantive benefit to public shareholders).

78. See supra text accompanying notes 40–42.

79. See supra note 77 and the remarks of former SEC Commissioner Longstreth. This alleged bias is further complicated because:

A problem in the application of this theory to fairness opinions lies in the lack of concrete standards in the investment banking community. It appears that, in determining value, the conduct of investment bankers, unlike accountants, is not governed by a set of industry guidelines other than those general factors that the Weinberger court laid out. Thus, the weight in a given case assigned to such factors as asset, market, dividend, and earning values is left largely to the discretion of the individual investment banker. Addressing the valuation techniques of two reputable investment bankers in one recent case, the Delaware court referred to the “questionable methodology employed” as well as the “quick and cursory” analysis used before concluding that “both the opinions of Morgan Stanley and of Goldman Sachs leave something to be desired.” Moreover, even when investment bankers use the same data for arriving at their opinions, they often express different opinions as to value.

Steinberg & Lindahl, supra note 48, at 399 (footnotes omitted).

80. See Hechler, supra note 28, at 971. A key aspect here, regardless of whether a leveraged buyout or hostile takeover bid is involved, is that incumbent management will continue to operate the enterprise on an ongoing basis.

81. See Lewis D. Solomon et al., Corporations, Law and Policy: Materials and Problems 1100 (1982) (“The [target’s] professional advisors, whether they are investment bankers or lawyers, are likely to lose a client, and, especially in the case of a lawyer, the loss may have serious consequences.”).

82. See, e.g., Maldonado v. Flynn, 597 F.2d 789, 794 (2d Cir. 1979).
economics. The loss of a major client often causes a financial setback for members of a law firm, and the loss of a few such clients may spell catastrophe.\textsuperscript{83}

Consequently, purportedly protective mechanisms may offer relatively little meaningful benefit to corporate and shareholder interests if boards of directors and committees comprised of disinterested directors are advised by counsel and investment bankers who have a material economic stake in maintaining the status quo. The inherent structural bias of the outside directors (and the more obvious pecuniary interests of the insiders),\textsuperscript{84} when combined with the opinions rendered by their professional advisers (e.g., counsel and investment bankers), normally will effectuate the response desired by incumbent management.\textsuperscript{85} Moreover, because such actions, taken to maintain the corporation as an ongoing viable entity,\textsuperscript{86} will be engineered by directors who are likely to be deemed disinterested (or independent) under the applicable case law,\textsuperscript{87} the business judgment rule will apply in


\textsuperscript{84} See supra text accompanying notes 34-42.

many jurisdictions to insulate such actions from successful challenge.  

The presence of structural bias has not been eliminated under the present corporate governance framework. Nonetheless, proper implementation of the "consultative" attorney's role in the takeover bid context and of the "counsel for the outside directors" in certain other acquisition settings, such as in squeeze-out mergers, may enhance corporate accountability with relatively minor costs. Although some directors may tend to retain advisers who are predisposed to rendering advice presenting justifiable grounds in favor of incumbent management, implementation of the following practices should lessen the potential for bias. First, the attorney and investment banker, separately retained, should be selected by the outside directors. Second, those advisers should have no professional or personal affiliations with any of the subject companies or their management. Third, if the advisers have engaged in this type of representation (such as serving as consultative attorney) on a fairly frequent basis, the advice rendered (providing that the position recommended is known) should not show a pattern of favoring management in nearly every instance. Fourth, during the representation, the insiders should convey pertinent information through counsel rather than directly communicating such information to the outside directors. Fifth, after the representation terminates, the separately retained counsel and investment banker should not be permitted to represent any of the subject entities for a substantial period of time, for example, five years.

88. Of course, certain requirements must be met before the business judgment rule may be invoked, including that the decision is (a) a deliberative one, (b) that was reasonably informed, (c) made by directors who acted in good faith without a disabling conflict of interest, and (d) with a rational basis. See Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Marc I. Steinberg, The American Law Institute's Draft Restatement on Corporate Governance: The Business Judgment Rule, Related Principles, and Some General Observations, 37 U. MIAMI L. REV. 295, 301-04 (1983). With respect to defensive measures undertaken by a subject board of directors in the tender offer setting to maintain the corporation as an independent, viable enterprise, Delaware law requires the board to show that there were "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and that the measure adopted was "reasonable in relation to the threat posed." Unocal, 493 A.2d at 955; see Omnicare, 818 A.2d at 927-28.

90. At times, these requirements may not be practical to implement on a rigorous basis. For example, there may be compelling circumstances present that should permit counsel to represent one of the subject entities before the expiration of the five-year period. Nonetheless, the burden should be placed upon the party seeking an exception to the enumerated practices. The gist of the practices is to help ensure, as much as feasible, that the board or a committee comprised of outside directors receives separately retained advice that is of a high caliber. Although perfection is not possible, any significant breach of the listed practices threatens the objectives sought to be achieved by the proposed framework.
Adherence to these suggested practices will reduce the potential for bias and, at the same time, will not have an adverse effect in procuring expert professional advice. Requiring that specially retained investment bankers and counsel (such as the consultative attorney or counsel for the outside directors) be selected by the outside directors, have no prior affiliation with the pertinent "actors," have not continually proffered advice favorable to management, and cannot thereafter be retained by the subject entities for a substantial time period significantly increases the likelihood that the board or committee will receive disinterested professional assistance. Moreover, by channeling communications through counsel, the parties most directly interested will have less opportunity to exert undue influence on a committee comprised of outside directors.

V. CONCLUSION

It may be asserted that the proposals herein are too formalistic and seek to implement a rigid monitoring mechanism. A survey of so-called disinterested board and committee determinations belies this assertion. In the aftermath of Enron and several other corporate debacles, one court opined that it "is well aware of the questions now being raised in the broader marketplace about the objectivity and responsibility of corporate directors." Indeed, proposals have been advanced that a corporation’s independent directors should have their own legal counsel on an ongoing basis. Viewed from this perspective, the suggestions set forth herein

91. Hence the insiders can communicate in this context to the outside directors comprising the committee only indirectly through the corporation’s general counsel (or through the insiders’ separately retained counsel if that is the case) who, in turn, will communicate with counsel advising the committee. This method of communication reduces the risk of undue influence by the insiders.


There are times . . . when the corporate lawyer must recognize that his or her own independence may be compromised by relationships with senior executive officers; at such times, the lawyer’s responsibility may require him or her to assure that the corporate client retains other counsel who can exercise the requisite professional detachment.

Id. Note, moreover, that under the Sarbanes-Oxley Act of 2002, a publicly-held corporation’s audit committee, which must be comprised solely of independent directors, has authority to retain its
represent a relatively modest, yet meaningful, measure to help correct the deficiencies that currently exist in the mergers and acquisitions area.