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Recent Developments in Risk Management

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Named by *U.S. News - Best Lawyers* as the 2014 "Law Firm of the Year" in the area of Ethics and Professional Responsibility Law, Hinshaw is devoted to representing and advising lawyers and law firms on all aspects of the "law governing lawyers."

Protecting the Attorney-Client Privilege in a Merger

Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLP, 80 A.3d 155 (Del.Ch. 2013)

Risk Management Issue: In a dispute between a former parent entity and the buyer of a former wholly owned subsidiary, which entity owns the former parent entity's attorney-client privilege with respect to the sale? What can the parent entity do to ensure the privilege does not pass to the buyer?

The Case: In September 2011, the plaintiff entities (referred to collectively as "Buyer") purchased Plimus, Inc. (Plimus), a Delaware Corporation, pursuant to a merger agreement. Plimus was the surviving corporation in the merger. Plimus' computer system was included in the assets acquired by Buyer in the merger.

Buyer commenced an action against the former shareholders and representatives of Plimus (referred to collectively as "Seller") alleging that Seller fraudulently induced Buyer to acquire Plimus. After bringing the suit – a full year after the merger – Buyer notified Seller that among the files in Plimus' computer system, it had discovered certain communications between Seller and Plimus' then legal counsel about the merger transaction. Seller asserted the attorney-client privilege over these communications, claiming that it, and not the surviving corporation, retained control of the attorney-client privilege that belonged to Plimus for communications regarding the negotiation of the merger.

Seller, however, had done nothing during the year following the merger to regain control over these computer records, and there was no evidence that Seller took any steps to segregate the communications before the merger or to excise them from Plimus' computer systems despite knowing that control of the computer system was passing to Buyer in the merger. Further, the merger agreement did not contain any provision excluding pre-merger attorney-client communications from the assets that were being transferred to Buyer in the merger as a matter of law pursuant to Delaware General Corporation Law (DGCL).

Buyer moved to have the court resolve the privilege dispute, and to determine, among other things, "that the surviving corporation owns and controls any pre-merger privilege of Plimus or, alternatively, that Seller waived any privilege otherwise attaching to the pre-merger communications."

The court began its analysis by interpreting Section 259 of the DGCL which provides that following a merger, "all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation. . ." Seller contended that the statutory term "all . . . privileges" did not include the attorney-client privilege – arguing that the Delaware legislature intended "privilege" to include only certain property rights and did not extend to privileges established by a rule of evidence.

The court found that Seller's interpretation was not plausible, and would conflict with the only reasonable interpretation of the statute – "that *all* means *all* as to the enumerated categories [in the statute], and that includes *all* privileges, including the attorney-client privilege." The court agreed with Buyer that the plain language of the statute did not leave "room for judicial improvisation." And under the plain terms of Section 259 of the DGCL, the attorney-client privilege – like all other privileges – passes to the surviving corporation in the merger as a matter of law.

In response to Seller's argument that interpreting Section 259 of the DGCL to include the attorney-client privilege would create serious public policy issues, the court stated that, "parties in commerce can – and have – negotiated special contractual agreements to protect themselves and prevent certain aspects of the privilege from transferring to the surviving corporation in the merger." Indeed, citing one of Seller's own cases, the court found that parties already knew how to protect themselves from this situation by addressing the privilege issue in the transaction agreements.

Moreover, the issue was not new or unique when the merger was negotiated, and had, in fact, been recognized by the Supreme Court at least 18 years before: "[W]hen control of a corporation passes, to new management; the authority to assert and waive the corporation's attorney-client privilege passes as well." *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S.343, 349 (1985). The Supreme Court also noted that, "[d]isplaced managers may not assert the privilege over the wishes of the current managers, even as to statements that the former might have made to counsel concerning matters within the scope of their corporate duties." *Id*.

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Accordingly, the court held that, absent an express carve out in the merger agreement, the privilege over all pre-merger communications, including those relating to the negotiation of the merger itself, passed to the surviving corporation in the merger, "by plain operation of clear Delaware statutory law under Section 259 of the DGCL."

In light of finding that the attorney-client privilege passed to the surviving corporation, the court determined that it did not need to address whether Seller waived the attorney-client privilege. From its emphasis on Seller's "lengthy failure to take any reasonable steps to ensure Buyer did not have access to the allegedly privileged communication," it is likely that the court would have, in any case, determined that the privilege had been waived by Seller's dilatory conduct.

Risk Management Solution: Protection of a parent/seller's pre-merger attorney-client communications must be considered from the commencement of negotiations of a merger or asset sale. From the moment the interests of the entities begin to diverge, the parent/seller should arrange for separate counsel for the subsidiary in connection with the sale. In addition, an express provision should be included in the transactional documents excluding transfer of the privilege itself, and a protocol put in place by the seller during negotiations to segregate potential privileged communications from physical and electronically maintained documents so that they can be more easily deleted or excised prior to the transfer. Silence on this issue will likely allow the buyer unfettered access to all the parent/seller's privileged communications with its in-house counsel in connection with the sale.

Consequences of Failure to Protect Client Confidential Information During Discovery - Sanctions

Apple Inc. v. Samsung Electronics Co., LTD. et al. (No. 11-01846, N.D. Cal. Jan. 29, 2014)

Risk Management Issue: What is the scope of law firms' duties to manage sensitive data in discovery and avoid inadvertent disclosures of confidential data subject to protective orders? What are the consequences of failing to meet their obligations?

The Case: California Magistrate Judge Paul S. Grewal recently issued an order in the seemingly endless *Apple v. Samsung* litigation, on motions for sanctions against Samsung and the Quinn Emanuel law firm for their inadvertent disclosure of confidential information and failure to rectify the disclosure.

On March 24, 2012, Quinn Emanuel, counsel for Samsung, posted an insufficiently redacted copy of Apple's expert David Teece's Initial Expert Report to an FTP site (the Teece Report) and emailed more than 90 Samsung employees with instructions for accessing the document. A junior associate working late one night had failed to fully redact Apple's confidential license terms from the Teece report. The insufficient redactions exposed the terms of several of Apple's confidential license agreements with other major players in the industry, including those with Nokia and Ericsson. Ultimately, over 200 people not authorized by the existing protective order received the document with the confidential license terms.

On December 22, 2012, in response to a request, a Quinn Emanuel senior associate emailed in-house attorney for Samsung, Daniel Shim, a copy of the insufficiently redacted Teece Report. A Quinn Emanuel junior associate reviewed the redactions again and identified the incomplete redaction. The junior associate immediately brought it to the attention of the senior associate and a partner. In response, the senior associate asked Shim to delete the email, but nothing more was done to contain or investigate the damage, and neither Apple nor Nokia were notified that there had been a disclosure as Samsung was required to do pursuant to the protective order. Further, in forwarding Shim a "clean" copy of the Teece Report, the senior associate also forwarded an email chain that highlighted for Shim precisely where the confidential information could be found in older versions of the document.

On July 1, 2013, Nokia's Chief Intellectual Property Officer, Paul Melin, filed a declaration in support of a motion for protective order that launched "a thousand accusations" against Samsung and Quinn Emanuel, and the current dispute ensued. In that document, Melin claims the head of Samsung's Intellectual Property Center, Seungho Ahn, had recited for him the precise terms of an Apple/Nokia license agreement in the course of a June 2013 Samsung/Nokia licensing negotiation, that Ahn admitted getting the information through his attorneys, and that Ahn had confidently declared "all information leaks."

At the first hearing on this matter, Apple and Nokia argued to the court that it appeared Samsung used the information disclosed in violation of Section 6 of the protective order to gain an advantage in the Samsung/Nokia licensing negotiations, current proceedings before the United States International Trade Commission and United States Federal Trade Commission and other litigation. Apple and Nokia argued they needed discovery to find out the details and the court obliged, authorizing substantial document production and depositions.

On November 8, 2013, the court issued an Order to Show Cause why sanctions were not warranted as to three particular violations of the court's protective order: (1) Samsung's wrongful use of the disclosed sensitive business information in preparing for negotiations and arbitrations with Ericsson and Nokia; (2) Quinn Emanuel's failure to fully redact sensitive business information from the Teece Report, resulting in the pervasive distribution to Samsung employees who were not authorized to have access to it; and (3) Quinn Emanuel's failure to follow the procedures set forth in Section 18 of the protective order after repeated notice of the disclosure of sensitive business information.

As to the first issue, the court concluded there was insufficient evidence to establish Samsung used information from the Teece Report to their advantage in licensing negotiations with Ericsson and Nokia.

As to the second issue, the court concluded that a Quinn Emanuel junior associate failed to properly redact the Teece Report, violating the court's protective order. Section 9(a) of the protective order defined the confidential information to include pricing information, financial data and licensing of Apple's intellectual property. The un-redacted portions of the report contained licensing terms for Apple's intellectual property. The failure to redact this information was a violation of the protective order. For the simple inadvertent error in redaction, however, the court did not issue sanctions.

As to the third and final issue, the court found that Quinn Emanuel violated the protective order requiring the firm to immediately notify counsel for Apple of the inadvertent disclosure of Apple's confidential information and that said violation merited sanctions. The incompletely redacted Teece Report was widely circulated within Samsung in violation of the protective order and those hundreds of violations merited sanctions due to the breadth/volume of violations and the fact Samsung and Quinn Emanuel made a conscious decision to set up a system that would allow violations of that scope to ensue from a small and predictable redaction mistake. Mr. Quinn described his firm as "650 lawyers wide and 1 layer deep." The court commented that in cases of this complexity, however, "relying on such a structure to manage highly confidential information . . . is akin to a trapeze artist flying high without a net."

Quinn Emanuel protested that in reality it did not know about the inadvertent disclosure and should not be held accountable for the lapse. The court stated that if no one at Quinn Emanuel was responsible for knowing what documents had gone out to the client, then "that is a flaw for which the firm must be held accountable." The court determined that Quinn Emanuel "should have 'immediately' picked up the phone to call Apple and let them know that there was a problem." Instead, it did nothing. The court emphasized that while a junior associate missing one redaction among many in an expert report is not exactly a historical event, such things can happen, and almost certainly do happen often. But when such an inadvertent mistake is permitted to go unchecked, unaddressed, and propagated hundreds and hundreds of times, more significant and blameworthy flaws are revealed.

The court ordered Quinn Emanuel to reimburse Apple, Nokia and their counsel for any and all costs and fees incurred in litigating the motion and discovery associated with it, seek prior approval from Apple's counsel before distributing or filing any redacted documents, and ensure that all copies of the expert report were deleted or otherwise permanently removed from Samsung's control. The court found there was insufficient evidence to show the failure to notify led to the misuse of confidential information that implicated any issue outside the litigation to justify harsher sanctions. The expense, in addition to the public finding of wrongdoing, was in the court's opinion, sufficient to remedy Apple and Nokia's harm, and to discourage similar conduct in the future. The court rejected other proposed sanctions as "ludicrously overbroad," including a 10-year ban against Samsung's counsel from representing any party adverse to Nokia.

Risk Management Solution: This is a case of lack of oversight. Law firms dealing with complex litigation matters with huge volumes of data at issue should first ensure their human infrastructure and technology are up to the challenge. Among other things, law firms can rely on mechanized processes to run targeted searches of key terms to make sure confidential information is adequately redacted. A "two sets of eyes" process is another way law firms can try to avoid inadvertent disclosure of privileged or confidential data. However, because human error is possible, law firms should adopt some method in addition to technology based searching that will function as the "net" Judge Grewal mentioned in his ruling. Ultimately, while a law firm's failure to properly redact private data during the discovery and production process is not unknown (and may be inevitable over the course of time), law firms must have a data oversight procedure in place not only to manage highly confidential information and ensure privileged and confidential data is properly redacted, but also to ensure the inadvertent production of confidential data is adequately and timely addressed and rectified.

Conflicts of Interest – Duties to Former Clients – Screening Procedures – What Are the Attributes of an Effective Screen?

Adaptix, Inc. v. Dell, Inc., E.D. Texas Case No. 6:13CV437 (February 12, 2014)

Risk Management Issue: How can a firm best avoid disqualification based upon conflicts arising from former representations of laterally hired lawyers?

The Case: Lodsys Group sued Dell for allegedly infringing upon a number of patents in products including printers, which were manufactured for Dell by Lexmark. Dell sought payment for its defense and its indemnification from Lexmark, which recommended Hayes Bostock & Cronin (HBC) as defense counsel. Dell agreed to the representation, but only after extensive negotiation of the terms of engagement with HBC, including limitations on HBC's future ability to represent plaintiffs against Dell.

Dell and HBC agreed that only those HBC lawyers, who worked on the Lodsys matter, and not the whole firm, would be precluded from representing a plaintiff against Dell for a 36 month period after the conclusion of that lawyer's representation of Dell in the Lodsys matter. The terms of this agreement included the following:

> Dell considers all patents matters to be substantially related to the [Lodsys matter] and considers representation of a plaintiff or entity asserting its patents against Dell in any patent matter to be a conflict. Dell expressly objects to any lawyer who views Dell confidential information or bills time to the [Lodsys matter] from representing a plaintiff against Dell for a period of 36 months after conclusion of the lawyer's representation of Dell in the [Lodsys matter].

Conflicts of Interest, continued on back page

HBC associates Gannon and DeBlois performed work and billed time for limited activities on the Lodsys matter, but neither entered an appearance for Dell.

In May 2013, HBC dissolved, and after July 1, 2013, HBC no longer represented Dell or any other party in the Lodsys matter. The HBC lawyers who performed most of the work for Dell in the Lodsys matter took the matter with them to their new firm, Nutter McLennan. The Lodsys matter was dismissed with prejudice on August 13, 2013.

Other ex-HBC lawyers, including Gannon and DeBlois, joined the Hayes Messina firm, which began operations on July 1, 2013. Hayes Messina had no attorney-client relationship with Dell. In September 2013, Hayes Messina began representing Adaptix in a patent infringement case against Dell.

As a precautionary measure, on July 3, 2013, Hayes Messina instituted a screening protocol for Gannon and DeBlois, which provided that neither would use or reveal any information relating to the Lodsys matter; that they would be screened from participation in and would not be apportioned fees from the Adaptix case; that Dell would be promptly notified of the screening protocol to ascertain compliance; and that Dell would be provided with a certificate of compliance. Dell complained that the protocol did not cure the conflict of interest, and sought to have Hayes Messina disqualified from representing Adaptix against it.

To successfully disqualify counsel for a former representation conflict, the movant must prove that the matters are substantially related or that the former attorney actually possesses relevant confidential information. The court applied the ABA Model Rules of Professional Conduct in deciding the issue. The court agreed with Adaptix that the conflict arose under Rule 1.9, involving former representation, rather than under 1.7 (concurrent conflict). The court noted that Dell continued to be represented in the Lodsys matter by ex-HBC lawyers at a different firm until the conclusion of that matter. Subsequently, Hayes Messina appeared in the Adaptix matter more than a month after the Lodsys matter was dismissed, and never had any attorney-client relationship with Dell.

The court reasoned that, "Dell is simply a former client of two former HBC attorneys who have now joined Hayes Messina and who billed only a few hours on the Lodsys matter and neither of which made an appearance in the case at any point." As a result, the court determined that the Lodsys and Adaptix matters were not substantially related (the former dealt almost exclusively with Lexmark printer technology) nor was previous counsel privy to any information relevant to the Adaptix matter. Accordingly, there was no Rule 1.9 conflict.

After determining that there was no conflict under Rule 1.9, the court nevertheless undertook what it called a "balancing approach" to consider whether disqualification was warranted even in the absence of a conflict. The court concluded that since Hayes Messina was already handling many pending Adaptix lawsuits, and the firm had familiarity and an ongoing relationship with Adaptix and since Gannon and DeBlois billed only minimal hours on Lodsys, which involved different patents and were not privy to Dell's confidential information, Dell's concerns did not outweigh Adaptix's right to choose its own counsel.

Despite finding there was no conflict and that disqualification was not warranted, the court went further and expressly approved the Hayes Messina screening protocol, which closely followed the requirements in Model Rule 1.10(a)(2). Although the court recognized that the size and structure of a firm can interfere with the effectiveness of screening protocols, it was unwilling to disallow procedures that so closely tracked the Rule's requirements.

Risk Management Solution: When faced with a potential conflict arising from a former representation, firms should immediately check the applicable rules for their jurisdiction relating to screening protocols. Some states have adopted ABA Model Rule 1.10(a)(2), which provides a useful checklist for law firms seeking to remain as counsel, including: 1) timely screening of the disqualified lawyer; 2) no apportionment of the fee from the representation to the disqualified lawyer; 3) prompt written notice to any affected former client describing the screening procedures, noting that review is available, providing a statement of the screened lawyer's rule compliance, and offering an agreement that the firm will respond promptly to written inquiries or objections; and 4) further compliance certifications provided at "reasonable" intervals and upon termination of the screening procedures. Because the rules will vary between jurisdictions, it is essential to consult all potentially relevant rules of the pertinent jurisdiction and comply with those rules. It is also notable that even in jurisdictions that have not adopted a screening rule such as Model Rule 1.10(a)(2), many courts will decline to disqualify law firms that have put timely and effective screen in place, even where such conflicts exist, so long as the courts are satisfied that there will be no "trial taint" resulting from the conflict.

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