

# Due Diligence, Fiduciary Duties & Disqualification

BY ROY SIMON

Last November the head of litigation at a major Wall Street law firm was talking about new developments in the field of legal ethics. "What do you think of Judge Gammerman's decision disqualifying Epstein, Becker & Green?" he asked. "Everybody is talking about that one." He was referring to *HF Management Services LLC v. Pistone*, N.Y.L.J. Feb. 24, 2005 (N.Y. County Supreme Ct. 2005), one of the most important unpublished decisions in a long time. The legal world - especially the big firm world - was buzzing about it. This column will discuss Judge Gammerman's decision in *HF Management* and the First Department's recent reversal of that decision (on June 27th) by a 32 vote - a result virtually guaranteeing that the case will end up before the New York Court of Appeals in the coming months.

## Background: Epstein Becker's Conflicting (?) Roles

In 2003, two companies called WellCare of New York, Inc. and WellCare Healthplans, Inc. (collectively "WellCare") decided the time was right for an IPO. WellCare arranged for Morgan Stanley to serve as lead underwriter. Morgan Stanley, in turn, retained Epstein, Becker & Green ("Epstein Becker") to perform due diligence relating to health care issues. WellCare then made its confidential files and its employees available to Epstein Becker, which spent over 800 hours during 2003 and 2004 reviewing those files and interviewing WellCare personnel. Among other things, Epstein Becker reviewed WellCare's business plans, its strategic and market analyses, its employee policies, and its recruitment and retention documents. Epstein Becker also talked with WellCare's head of litigation and its general counsel about WellCare's various litigations and litigation strategies, including WellCare's litigation strategy in certain actions that other companies had brought against WellCare alleging breach of employee nonsolicitation agreements and unfair competition.

In August 2004, HF Management ("HF") retained Epstein Becker to file suit against WellCare, alleging that WellCare had solicited HF employees in violation of anti solicitation clauses contained in the employees' contracts, and that the improper solicitation was part of a practice by WellCare of employee raiding. This was the same kind of litigation that Epstein Becker lawyers had discussed with WellCare's head of litigation and its general counsel during the due diligence for Morgan Stanley less than a year earlier.

WellCare moved to disqualify Epstein Becker on the ground that during its due diligence for Morgan Stanley, the firm had been given access to "sensitive, confidential information" substantially related to HF's current action.

Epstein Becker opposed the motion to disqualify. It argued that no conflict of interest existed because Epstein Becker had never formed an attorney client relationship with WellCare regarding the IPO. Therefore, none of the communications between Epstein Becker and WellCare were privileged. To the

contrary, Epstein Becker asserted, Epstein Becker had "an affirmative obligation to disclose adverse information about WellCare to its client, Morgan Stanley" - the very antithesis of privilege.

Epstein Becker also argued, as fallback positions, that HF's case against WellCare was not substantially related to Epstein Becker's due diligence about WellCare, and that in any event the lawyers who had conducted the due diligence at WellCare had no involvement in the HF case. Those arguments are outside the scope of this column. The only issue addressed here is whether Epstein Becker was prohibited from opposing WellCare because it had conducted due diligence at WellCare in connection with the IPO.

### **Judge Gammerman's Decision**

Judge Gammerman rejected Epstein Becker's arguments and granted the motion to disqualify. Because his opinion was never published outside the New York Law Journal, I will quote in full (without most citations) those portions of his opinion dealing with the due diligence issue:

[C]ontrary to EBG's contention, the lack of a formal attorneyclient relationship between EBG and WellCare is not dispositive. While there is language in the reported cases to the effect that disqualification requires a showing of an attorneyclient relationship, see e.g. *TekniPlex, Inc. v. Meyner and Landis*, 89 NY2d 123 (1996), the crux of disqualification is not the attorneyclient relationship itself, but the fiduciary relationship that results from it, a relationship that imposes a duty not merely to protect privileged attorneyclient communications, but other confidential matter as well.

In *Greene v. Greene*, 47 NY2d 447 [1979], two partners in plaintiff's law firm had formerly been partners in the law firm that plaintiff was suing. The Court of Appeals held that plaintiff's firm was disqualified because, inter alia:

As former partners in defendant law firm, Grutman and Bjork owe a fiduciary obligation similar to that owed by an attorney to his client. This is especially so with respect to Grutman, a former managing partner of the firm. Defendant relates, in its affidavits, that Grutman and Bjork gained confidential information in their capacity as members of the firm. Indeed, it is alleged that one or both of them were privy to partnership discussions concerning the firm's potential liability for its management of plaintiff's trust. In view of these allegations, we cannot discount the possibility that information obtained by Grutman and Bjork in their role as fiduciaries will be used in the pending lawsuit.

Thus, the former partners obtained confidential information about the defendant in the course of professional activities that were characterized by a fiduciary obligation, not an attorneyclient relationship.

The same principle applies here. As Morgan Stanley's agent in the IPO, EBG shared Morgan Stanley's fiduciary duty to WellCare. Morgan Stanley, as underwriter, owed a fiduciary duty to WellCare and may not profit from corporate information gained in its capacity as underwriter. EBG obtained confidential (or, more accurately, to use the terminology of the Code of Professional Responsibility, secret) information from WellCare in the course of rendering professional services under circumstances that imposed on it a fiduciary or special obligation to disclose that information solely to Morgan Stanley, so that Morgan Stanley could use it for the purposes for which the firm was retained by its direct client. It obtained that information in the context of a relationship that

encouraged WellCare to disclose confidential information to EBG. EBG's own papers acknowledge that "communications with WellCare personnel were understood to be, and were, confidential," and that EBG "was not entitled to share the information it learned about WellCare with the public, particularly prior to the effective date of the IPO." While that information could have been disclosed to Morgan Stanley in connection with Morgan Stanley's services as IPO underwriter, EBG does not, and could not, deny that neither Morgan Stanley nor EBG had the right to utilize confidential information about WellCare obtained during the due diligence process, for any other purpose, let alone for other purposes adverse to WellCare's interests.

The remainder of Judge Gammernan's decision was devoted mainly to discussing whether Epstein Becker could avoid disqualification by erecting a "Chinese Wall" between the lawyers handling the HF case and the lawyers who had handled the due diligence. That issue became irrelevant when the First Department rejected Judge Gammernan's underlying premise that Epstein Becker owed a fiduciary duty to Wellcare.

### **The First Department's Decision**

The First Department, in an opinion by Judge Catterson, reversed by the narrowest of margins. In fact, only four judges heard oral argument, and only when those judges split two two did the First Department summon a fifth judge to break the tie.

The majority in the First Department acknowledged that "in certain instances where no formal attorney-client relationship exists, a fiduciary obligation has been sufficient grounds for attorney disqualification." A fiduciary relationship exists between two persons, the court said, "when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation." Determining whether a fiduciary relationship existed is "fact specific," but "generally no such relationship exists between those involved in arm's length business transactions." Accordingly, New York law "essentially does not recognize the existence of a fiduciary obligation that is based solely on the relationship between an underwriter and issuer."

To underscore this point, the First Department closely examined the Court of Appeals' recent decision in *EBC I v. Goldman Sachs & Co.*, 5 N.Y.3d 11, 19 (2005). In *EBC I*, the court held that the typical contractual relationship between an underwriter and issuer, based on an underwriting agreement, does not by itself create any fiduciary obligations. The relationship between an underwriter and an issuer in connection with an IPO, the Court of Appeals said, was essentially a relationship between a buyer and seller, where typically the issuer sells an entire allotment of shares to an investment firm that intends, in turn, to sell those shares to the public. Nevertheless, the Court of Appeals in *EBC I* allowed for a "fiduciary obligation exception" where there was "a preexisting relationship created independently and apart from the contractual one." In *EBC I*, for example, an Internet retailer known as eToys alleged that it had hired Goldman Sachs as lead managing underwriter based on its knowledge and expertise, to advise eToys as to a fair IPO price "with eToys' best interest in mind." If eToys could prove that it relied on the advice and expertise of Goldman Sachs, the Court of Appeals held, that would have created a relationship of "higher trust" resulting in a fiduciary obligation of underwriter to issuer. But in the view of the First Department in *HF Management*, the decision in *EBC I* was "the exception that proves the rule." As the Court of Appeals itself had stated there: "We stress that the fiduciary duty we recognize is limited to the underwriter's role as advisor. We do not suggest that underwriters are fiduciaries when they are engaged in activities other

than rendering expert advice." Indeed, the Court of Appeals unequivocally stated that the fiduciary relationship alleged by the parties in *EBC I* was "beyond that which arises from the underwriting agreement alone."

The facts before the First Department in *HF Management* fell outside this exception. "[N]othing in the record even remotely suggests that the relationship between Morgan Stanley and WellCare rose above the typical contractual relationship of an underwriting agreement between a buyer and a seller," wrote Judge Catterson. "Both parties were separately counseled" - the underwriting agreement specifically identified EBG as the "special regulatory counsel for the underwriters" and acknowledged that another law firm was serving as outside counsel for WellCare. Nothing indicated or suggested that Morgan Stanley and WellCare enjoyed any type of preexisting relationship, or that Morgan Stanley had acted as an "expert advisor on market conditions" to WellCare in the same way that Goldman Sachs had allegedly advised eToys.

The First Department recognized that the Court of Appeals had not decided *EBC I v. Goldman Sachs* until almost four months after Judge Gammerman disqualified Epstein Becker in *HF Management*. But in holding that the typical underwriter issuer relationship was not a fiduciary relationship, the Court of Appeals "was not creating new law. It was simply reiterating the principles of a 'long established and well understood' contractual relationship between underwriter and issuer." Courts in New York and courts in other jurisdictions applying New York law "have long recognized the nonfiduciary nature of the underwriter issuer relationship." In fact, the First Department said, "such relationships are better characterized as adversarial since the statutorily imposed duty of underwriters is to investors." Under the Securities Act of 1933, the underwriter must prepare a registration statement providing full and adequate information to investors concerning the issuing company. As provided in 15 U.S.C. §77g, a registration statement must contain information and documents "necessary or appropriate in the public interest or for the protection of investors."

Here, in its role as underwriters' due diligence counsel, Epstein Becker was "charged with the task of uncovering such documents and information about WellCare and reporting it to the underwriter." Based on due diligence counsel's report, underwriters like Morgan Stanley either make the appropriate disclosures in the offering materials, or decide that the offering is not feasible. "To the extent that the information and documents may be unfavorable to the issuer, a fiduciary obligation would almost certainly create a conflict with the underwriter's duty to potential investors."

Thus, since Morgan Stanley itself owed no fiduciary duty to WellCare, no fiduciary duty could be imputed to Epstein Becker as Morgan Stanley's due diligence counsel.

Nor would it make any sense under the federal securities laws to create a fiduciary duty running from underwriter's counsel to the issuer. Under § 11 of the Securities Act, 15 U.S.C. §77k, an underwriter may assert a defense against liability for material misstatements in a registration statement if it performed due diligence, but the due diligence defense is not available to the issuer. Consequently, there is "no conceivable basis for any conclusion that the due diligence is being performed for the issuer's benefit."

Epstein Becker also has no confidentiality obligation regarding the information it gathered from WellCare because WellCare provided the information for the purpose of preparing public documents (the registration statement and the IPO prospectus), which obviously are not confidential.

WellCare argues that not all of the information gathered was actually published in the documents connected with the IPO. Yet denying disqualification here is entirely consistent with cases refusing to disqualify a law firm that received confidential information under circumstances that did not give the party supplying the information the right to believe that the attorneys would respect the confidences.

WellCare also argues that, even though it had no "formal" attorney client relationship with Epstein Becker, there were nevertheless "sufficient indicia" of an attorney client relationship to justify disqualification. That argument is without merit. Disqualification on that basis is "limited to circumstances where the nonclient ... shares with the actual client ... a joint interest that is being advanced on both the client and nonclient's behalf." Here, such a jointly held interest could arise only out of an existing fiduciary relationship, but no fiduciary relationship existed.

### **The Dissenting Opinion**

Judge Andrias, joined by Judge Nardelli, dissented. Their main argument was that the confidential information obtained by Epstein Becker in its work for Morgan Stanley "may be reasonably perceived as placing such confidences in jeopardy of disclosure to plaintiff ...." Epstein Becker obtained that confidential information in the due diligence process "within the context of a fiduciary relationship." Judge Gammerman correctly found that a fiduciary relationship existed between Morgan Stanley and WellCare, "at least to the extent that Morgan Stanley was bound to preserve from adverse use against WellCare in other contexts confidential information elicited from it to facilitate the underwriter's due diligence." This duty was properly imputed to Epstein Becker because it was Morgan Stanley's counsel.

The crux of disqualification "is not the attorney client relationship itself, but the fiduciary relationship that results from it." Whether or not Morgan Stanley, in its capacity as underwriter, was a fiduciary in the "limited sense" that Goldman Sachs was found to be a fiduciary in *EBC I* (*i.e.*, in its role as an expert advisor), the result should be the same. In *EBC I*, the Court of Appeals "merely held that the parties had created their own relationship of higher trust which required Goldman Sachs to deal honestly with its client and disclose its conflict of interest."

Here, Morgan Stanley in its role as underwriter and as part of its relationship with WellCare, undertook to conduct the due diligence work necessary for the public offering of WellCare stock. Morgan Stanley retained Epstein Becker as its agent for that purpose. In its role as Morgan Stanley's agent, Epstein Becker obtained "secret" information from WellCare within the meaning of DR 4101(A) of the New York Code of Professional Responsibility. If Epstein Becker had not been conducting due diligence as Morgan Stanley's agent, it would not have been privy to that information. Thus, the dissent said, even if Epstein Becker was not a fiduciary advisor, the firm "at the very least ... owed WellCare a fiduciary or special obligation not to disclose to anyone other than Morgan Stanley the 'secret' information obtained by it in the course of rendering professional services to Morgan Stanley ...."

Accordingly, the dissent would have affirmed Epstein Becker's disqualification.

## Who Is Right?

Who has the better argument in the HF case - the majority, or the dissent?

On one hand, everyone agrees that WellCare was never actually a client of Epstein Becker, and therefore does not fit neatly under DR 5108(A) of the New York Code, which prohibits a law firm from opposing a former client in a substantially related matter absent the former client's consent after full disclosure. Yet if WellCare were accorded the rights of a former client as a matter of law, it could prevent Epstein Becker from representing anyone against it in any matter substantially related to the matter in which the firm acquired WellCare's confidential information. Treating WellCare as if it were a former client would thus put a powerful veto in the hands of any party complying with an underwriter's due diligence procedures.

On the other hand, when WellCare shared its sensitive confidential information with Epstein Becker, it fully expected that information to be kept secret unless the securities laws required the underwriter to disclose specific information - and certainly WellCare did not expect its confidential information to be used against it by the very law firm that obtained access to the information under the umbrella of performing due diligence on behalf of the underwriter.

The question, then, is whether to accord an issuer the status of a former client for conflict of interest purposes if the issuer has given the underwriter's law firm confidential information in the course of the underwriter's due diligence.

From a policy standpoint, we should examine the rationales underlying the former client conflict rule (DR 5108) and determine whether they apply in the due diligence situation. The main purpose of DR 5108 and its well established "substantially related matter" test is to ensure that a client's confidences and secrets are protected after an attorney client relationship ends, thus encouraging the client to confide in the lawyer about all possibly relevant information. If a client thought that its lawyer could use the client's confidential information against it once the attorney client relationship terminated, the client might hold back important information from the lawyer, hindering the lawyer's efforts to provide the best possible representation. To encourage clients to be candid with their lawyers during the representation, we promise clients ironclad protection of their confidential information after the representation.

We even pile on this protection four layers deep. The first layer of protection is DR 5108(A)(2), which forbids a lawyer to "[u]se any confidences or secrets of the former client except as permitted by DR 4-101(C) or when the confidence or secret has become generally known." The second layer is DR 5108(A). Because a lawyer might find it difficult not to use confidences and secrets against the former client in matter with overlapping facts and legal issues, a lawyer may not oppose a former client in a substantially related matter without consent. As a third layer, to ensure that the substantially related standard itself does not intrude on the former client's confidences and secrets, we do not ask whether the lawyer actually received confidences and secrets in the prior matter, but instead we presume that the lawyer received them if the matters are substantially related. The fourth layer of protection is the imputation rule, DR 5105(D), which prohibits not only the individual lawyer from opposing his or her own former client in a substantially related matter without consent, but also extends the prohibition to the lawyer's entire law firm.

Should we accord such powerful quadruple layer protection to a party that never attains the status of an actual client? In some situations, the courts have said yes. In the trade association setting, for example, if a member of a trade association supplies the trade association's lawyer with confidential information to advance the association's interests, then we treat the member as the lawyer's "vicarious client" and prohibit the lawyer from later opposing that client in a substantially related matter. *See, e.g., Glueck v. Jonathan Logan, Inc.*, 653 F.2d 746, 749 (2d Cir. 1981); *Westinghouse Electric Corp. v. KerrMcGee Corp.*, 580 F.2d 1311 (7th Cir. 1978). Here, I think the First Department majority was right to deny disqualification for at least eight reasons.

First, as the First Department majority recognized in *HF Management*, the issuer is obligated by the federal securities laws to be candid with due diligence counsel. Withholding material information could lead to securities fraud charges against the issuer, with potentially enormous civil and even criminal consequences. Given this strong incentive for the issuer to make full disclosure, the fourfold protections of DR 5108 are unnecessary.

Second, the problem can readily be solved by contract. If an issuer like WellCare wants to ensure that the law firm performing due diligence will not later oppose it in a substantially related matter, the issuer can negotiate that term into its contract with the underwriter, or can condition access to its confidential information on a contractual agreement with due diligence counsel. As a general policy, I do think courts should hesitate to impose duties as a matter of law (*i.e.*, as a matter of fiduciary duty) when the parties themselves are fully capable of negotiating the same duties as a matter of contract. An issuer's insistence on such a term might kill the deal, because the underwriter's top choices for due diligence counsel might reject this condition, and the underwriter might be unwilling to do the offering using a second string (or third string) law firm as its due diligence counsel - but the issuer could still protect its confidential information by canceling the planned stock offering (thereby avoiding due diligence entirely). That's a tough choice, but if protecting confidential information is more important to the would be issuer than raising capital, so be it.

Third, the most capable law firms might cut back on their due diligence engagements if each such engagement would, as a matter of law, preclude the firm from later taking on any representation adverse to the issuer in a substantially related matter (at least without the issuer's consent, which we can assume would seldom be provided). If capable law firms turn down certain due diligence engagements to avoid later disqualification, that might impede the public policy goal of providing full and complete information to investors.

Fourth, as the First Department majority explained, the common law of fiduciary duties would still protect an issuer's confidential information in certain circumstances (*e.g.*, when the underwriter is serving as an "expert advisory," as in *EBC I v. Goldman Sachs, supra*), so rejecting Judge Gammerman's doctrine would not strip issuers of all legal protection.

Fifth, underwriters can play the role of watchdog over the law firms they hire as due diligence counsel to make sure those firms do not abuse their unfettered access to the issuer's confidential information. If major issuers complain to an underwriter about the ethics of a particular law firm, or if the underwriter's own reputation suffers because the law firms it selects as due diligence counsel are suspected of misusing confidential information against issuers in later engagements, the underwriter is well positioned to

discipline the law firm by not retaining it again. We do not need a new legal doctrine to assist powerful underwriting firms in keeping their due diligence counsel in line.

Sixth, if an issuer is given the right to disqualify due diligence counsel in future substantially related matter, it will have an incentive to "game" the system by disclosing information of marginal relevance (or no relevance), thus broadening the range of future matters in which due diligence counsel will be disqualified. Conversely, due diligence counsel will have an incentive not to explore areas of marginal relevance, thus narrowing the range of matters in which it can later be disqualified.

Seventh, it is hard to see where the new doctrine would stop. The doctrine would not be invoked only by issuers. Every person who supplied confidential information to another party's lawyer, for any reason, would be likely to invoke Judge Gammerman's doctrine to seek disqualification of that party's lawyer as opposing counsel in any later matter that is even arguably substantially related to the matter in which the person supplied the confidential information. Every one of those motions would be fact intensive and would require substantial judicial resources and many hours of lawyer time.

Eighth, - and this is a more philosophical reason - we should not lightly extend the protections of the attorney client relationship to persons who are not (and never were) clients. The attorney client relationship is a sacred relationship and is the fundamental building block on which the Code of Professional Responsibility rests. When we attempt to spread the protections of the Code of Professional Responsibility over those who do not literally fit within its terms, we risk diluting the protections extended to genuine clients who do fit within its terms. That is a risk the courts should not take.

## **Conclusion**

The First Department's reversal of Judge Gammerman was by the narrowest of margins, but it was the right call. Courts should not treat issuers as if they are the former clients of due diligence counsel hired by underwriters. The strong protections accorded to client confidences and secrets are essential to the proper functioning of our adversary system. Courts should not lightly extend these strong confidentiality protections to nonclients, especially where other mechanisms and incentives can accomplish the same purpose.

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