CORPORATE COUNSEL

What's an In-House Attorney to Do if a Client Is Hiding Assets in a Merger?

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In a recently filed lawsuit, the former general counsel of tech startup Lemon is accused of hiding intellectual property assets ahead of the company's sale to a larger company. Legal ethics experts say the case illustrates the complex ethical rules GCs must navigate during an M&A deal—including a duty to not make fraudulent misrepresentations to a buyer.

As reported on Law.com, identity theft protection company LifeLock Inc. sued Lemon's former GC, Cynthia McAdam, and Lemon's former CEO, Wenceslao Casares, on Sept. 19 in the Delaware Court of Chancery. LifeLock alleges that the duo "hatched a plan to keep for themselves very promising and potentially lucrative portions of Lemon's IP" while negotiating the 2013 merger of LifeLock and Lemon. The complaint alleges fraud and breach of contract, among other claims.

According to the complaint, at the time of its sale, Lemon had been developing valuable bitcoin payment technology. LifeLock alleges that McAdam and Casares, hoping to be the ones to commercialize this revolutionary technology, hid this technology from LifeLock during the due diligence process. McAdam is accused of erasing data files and wiping clear her data hard drive.

The claims made by LifeLock are "baseless" and just an attempt to cause "grief and embarrassment," says Steven Ragland, a partner at Keker & Van Nest who is representing McAdam and Casares. "The entire lawsuit is premised on demonstrably false allegations," he says.

During an M&A deal, a GC's first ethical duty is to the company he or she works for, says Jack Tanner of the Colorado law firm Fairfield and Woods. "The general rule is that lawyers cannot disclose anything about representation of the clients without the client's consent," Tanner says.

But if a company is committing a crime or fraud, a GC is allowed—but not required—to disclose this to the other party to the transaction, according to ethics rules.

And then there are situations when a lawyer may be required to disclose, says Thomas Mason, a partner at Harris, Wiltshire & Grannis in Washington, D.C. If a company is hiding assets but "the lawyer has made representations that these are all of our assets, then the lawyer is in a situation where they are making representations that they then have to disavow. And that's mandatory, in my view," he says.

Essentially, keeping quiet is not always the right choice for the in-house lawyer, Mason says. "The basic point is that if a lawyer is involved in or learns of a client's crime or fraud, the lawyer has to stop being involved and then has to at least think about disclosure and in some instances may be required to disclose."

Adding to the uncertainty is that the GC's client may change in a merger, Tanner says. "If it's a true merger, the buyers would essentially become the client. So the in-house counsel would work for the buyer," he says. "The ethical rules could require the lawyer to report to the new president all of the [shady dealings] that went on before. It would really depend on the precise language of the deal."

The GC is also required to report the behavior to the highest people in the company, Tanner says. "If you find out midlevel management is doing this, you have to report up the ladder," he says. "If the lawyer found out that their client was committing fraud, and they tried to get their client to change directions and that didn't work, they'd do what's called a noisy withdrawal … to suggest to people that they should take a closer look at what's going on."