

AN ETHICS PRIMER FOR BUSINESS LAWYERS

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Introduction

The author is Chair of the Professional Responsibility Committee of the ABA Section of Business Law. In that capacity he has written for the Section's electronic newsletter, "eSource," a series of short articles geared for lawyers who practice business law but who are not legal ethics experts. This guide, which incorporates much of that material, should be useful to litigators, as well as transactional lawyers.

Conflicts of Interest – Current Clients.

The basic rule is ABA Model Rule 1.7(a)(1), of which all states have a version. It provides that a lawyer, or law firm, may not take on a matter that is directly adverse to a current client. The rule does not care whether the new matter against the client has any relationship whatever to the other matter being handled for the client. In the blink of an eye we have glossed over two important concepts: (1) what is "directly" adverse; and (2) what is a "current" versus "former" client. Before getting to those concepts, let's discuss the relationship point.

No relationship. Law Firm's Newport Beach office represents Ajax Corp. in a property tax dispute with Orange County, and that matter is pending. Now NJ Bancorp asks Law Firm's Newark office to represent it in a major loan transaction in which Ajax Corp. is the borrower. The matters could not be more unrelated. Yet, Law Firm would have a current client conflict that could only be cured with a waiver. Many fine lawyers think that rule is silly. Tough; that's the rule.

Current client. As we will discuss, the above rule changes if the client is a former one instead of a current one. Then, relationship, or the lack thereof, matters. So, is the client current or former? Suppose the Orange County tax dispute was resolved a few months before the NJ Bancorp loan came in, and Law Firm has no other matters pending for Ajax Corp. We would love to give you some guidelines for this, but we cannot. State and federal courts around the country have wildly disparate views of what is "current" and what is "former." For example, in *Oxford Systems, Inc. v. CellPro, Inc.*, 45 F. Supp. 2d 1055 (W.D. Wash. 1999), the law firm had done nothing for the client for a year. Yet, because the client pretty much limited what it did have to that law firm, the court held the client was current. In contrast, in *Artromick Int'l Inc. v. Drustar, Inc.*, 134 F.R.D. 226 (S.D. Ohio 1991), about a year had elapsed since the law firm had done any work for the client. A small invoice remained outstanding. The firm sent at least one piece of promotional material to the client during that year. Nevertheless, the court refused to disqualify the firm when it showed up on the other side of a case. For a very recent, and

nuanced, discussion of when a current client becomes a former client, *see Metropolitan Life Ins. Co. v. The Guardian Life Ins. Co. of America*, 2009 U.S. Dist. LEXIS 42475 (N.D. Ill. May 18, 2009).

Direct adversity. Handling a lawsuit on behalf of Client A against Client B is obviously direct adversity. Likewise, sitting across the table from a current client in a major and contentious workout negotiation is direct adversity. Beyond those clear examples, things can be fuzzy. For example, Law Firm represents Family Patriarch in a variety of matters, including his estate plan. At the same time Law Firm represents the Patriarch's son on a variety of matters, some of which are pending. Patriarch, disgusted with his son over something, asks Law Firm to remove the son from his will. That seems "direct," doesn't it? Yet, the influential ABA Standing Committee on Ethics and Professional Responsibility ("ABA Ethics Committee"), in its Formal Opinion 05-434 (December 2004), held that in that precise situation Law Firm would not have a conflict and would not need a waiver from the son.

Lesson: "don't try this at home." This is about issue spotting. Hopefully, when you are confronted with these issues you will have access to personnel who have a better handle than you on the nuances of conflict-of-interest law.

Conflicts of Interest – Former Clients

As we saw above, the most important rule with respect to current clients is that a lawyer may not be directly adverse to a current client even though the adverse matter bears no relationship to matters the lawyer handles for that client. The rules shift subtly when the lawyer is asked to take a position adverse to a *former* client. When does a current client become a former client? We discussed that above. What we learned is that courts vary dramatically in their analysis of the current-vs.-former client issue.

Let us assume that the client in question is clearly *former* rather than *current*. That takes us to ABA Model Rule 1.9(a), which provides that a lawyer may take a position "materially adverse" to a former client if the matter is not "substantially related" to what the lawyer had done for the former client. More has been written about what is "substantially related" than just about any issue under the ethics rules. While it is easy to oversimplify, let us just say that the substantial relationship test is about *information*. Did the lawyer learn something from, or about, the former client in the earlier representation that would give the lawyer an advantage in opposing the former client in a current matter?

A clear case: Lawyer is representing Client in a contentious merger negotiation with Opponent. After many weeks of wrangling, Client becomes fed up with Lawyer and fires Lawyer, saying, in effect, "I never want to see you again. Here is your fee. Goodbye." A month later Lawyer shows up on Opponent's legal team in that same negotiation. Lawyer obviously learned much information from, and about, Client in the earlier phase of the negotiation that would be enormously useful to Opponent. That is precisely what Model Rule 1.9(a) was designed to prevent.

A less clear case: Lawyer has handled dozens of acquisitions for Mammoth Corp. The most recent one was 18 months ago. After the last closing, Mammoth Corp. dismissed Lawyer and her law firm. Mammoth recently commenced a new series of acquisitions with a new law firm. One of Mammoth Corp.'s new acquisition targets is Small Corp. Small Corp. wants to hire Lawyer to handle the Mammoth Corp. transaction. Lawyer's earlier work for Mammoth did not involve Small Corp., but rather a number of different targets. However, the in-house lawyers and corporate executives at Mammoth working on the Small Corp. acquisition are the same people that Lawyer worked with while Lawyer was representing Mammoth. Lawyer knows how they think and knows their negotiating strategies very well. Lawyer, in effect, has their "playbook." Courts are inconsistent about whether playbook information should disqualify a lawyer from being adverse to a former client. A recent case holding it should disqualify the lawyer is *Hurley v. Hurley*, 923 A.2d 908 (Me. 2007). However, in *Vincent v. Essent Healthcare of Conn.*, 465 F. Supp. 2d 142 (D. Conn. 2006) the court refused to disqualify a lawyer in the face of playbook arguments. There are many cases on both sides of this issue. For a superb discussion of the "playbook" view of the substantial relationship test, see Charles W. Wolfram, *Former-Client Conflicts*, 10 Geo. J. Legal Ethics 677 (1997).

A word about waivers: We discuss them below. However, we should make one observation about waivers in the former client context. Do not assume that a waiver is feasible in such a case. Suppose a lawyer has doubts about whether a matter is substantially related to an earlier matter. She asks the former client for a waiver. The former client refuses. The request for a waiver could be construed as an admission that one was required. Or, suppose that the former client asks whom the lawyer plans to represent and all the details of the new matter, which an astute former client would do. Can the lawyer provide that information, or would doing so violate the lawyer's duty of confidentiality to her new client? We have just scratched the surface of the issues raised by conflict waivers in former client situations.

Conflicts of Interest – Waivers/Consents

"Waiver" vs. "Consent." We are not aware of any distinction between these two terms in the legal ethics literature. We prefer "waiver," and that is what we will use.

Are some conflicts un-waivable? Yes. Model Rule 1.7(b)(3) specifically prohibits a waiver for a lawyer to be on both sides of "the same litigation or other proceeding before a tribunal." We are not aware of a state with a contrary rule. As to all other situations, Model Rule 1.7(b)(1) provides that a waiver will work if:

- (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; . . .

What does that mean? It is mostly a common-sense test because there is not much guidance in the literature. Certainly, some clients lack the sophistication to understand how a conflict might affect them. Even as to sophisticated clients, good transactional lawyers know that some deals require resolution of so many complex and contentious issues that the same lawyer would be foolish to attempt to represent more than one party.

Need for written waiver. Some states have always required that conflict waivers be in writing. Some have not. The ABA added a requirement for writings at Model Rule 1.7(b)(4) in 2002. All it requires is that the waiver be “confirmed in writing.” The Comment explains that the writing need not be signed by the party waiving and that the writing need not occur prior to the representation but “within a reasonable time” after the client waives orally.

Joint representations and confidences. When a lawyer attempts to represent more than one client in litigation or in a transaction, there is always a tension between the lawyer’s duty to keep all clients informed and the duty to protect each client’s confidences. Suppose two individuals ask a lawyer to represent them in the formation of partnership and the purchase of a business. One day one of the clients calls the lawyer and reveals that he has been prosecuted for fraud in two earlier matters, but does not want his partner to know about it. The lawyer’s dilemma is clear. That is why ethics experts recommend that any waiver or joint representation agreement contain a clause that the lawyer will not keep a secret of one client from the other(s), where the secret is related to the representation.

Advance waivers. Law Firm has been adverse to HugeBank in loan transactions and litigation on many occasions and will be in the future. HugeBank wants to retain Law Firm on one highly specialized advertising matter. Almost certainly, Law Firm can obtain effective waivers from HugeBank for existing, identifiable, matters. But, Law Firm is reluctant to take on the advertising matter, because it will prevent Law Firm from taking on future, unknown, matters adverse to HugeBank. Can law firm obtain from HugeBank a waiver for future matters, including matters that come in while the advertising representation continues? Probably yes. Comment [22] to Model Rule 1.7 generally favors such waivers, particularly if the party waiving is “an experienced user” of “legal services.” The Comment’s suggestion, and the suggestion of most courts addressing the issue is that the less sophisticated the client, the more specific the advance waiver has to be regarding the nature of the future matters. All agree that if the law firm wants to take on *litigation* against the waiving party, the waiver must specifically mention litigation. Caution: a small minority of courts may never approve an advance waiver. *See, e.g., Worldspan L.P. v. The Sabre Group Holdings, Inc.*, 5 F. Supp. 2d 1356 (N.D. Ga. 1998); and *Celgene Corp. v. KV Pharm. Co.*, 2008 U.S. Dist. LEXIS 58735 (D.N.J. July 29, 2008).

Conflicts of Interest – The Underlying Work Problem

Law Firm handles a transaction, including negotiating for Client, preparing the important documents, and the like. The closing is uneventful, and the parties begin performing their respective obligations. The sea is calm. Then, when the parties reach a major milestone, they find that they are in substantial disagreement about who owes what to whom. Client returns to Law Firm, says that only litigation will resolve the issues, and asks Law Firm to handle the litigation.

Should Law Firm have second thoughts about the litigation engagement? For much of

history law firms did this all the time. But, times have changed. Malpractice insurance professionals have been concerned about this scenario for the past 15 years, or so. The concern is that if Law Firm loses the case, Client will claim the law firm had a conflict of interest and handled the case in a way to deflect attention from Law Firm's own work on the transaction. Indeed, we are aware of a number of cases in which this conflict appeared to make the malpractice case impossible to try. The conflicts were just too dangerous, and the cases were quietly settled. That explains, in part, why there had been no reported malpractice cases with this scenario until recently.

In 2007, within the space of a week, two opinions appeared, one clearly relevant, and one possibly so. The first, and clearer, was *Veras Investment Partners, LLC v. Akin Gump Strauss Hauer & Field LLP*, 851 N.Y.S.2d 61 (N.Y. Misc. 2007). The reader should keep in mind that the opinion only addresses a motion to dismiss, and the court was required to accept the allegations of the complaint as true. The facts, when developed, may tell a very different story. Nevertheless, according to the complaint Law Firm advised and assisted Clients in setting up hedge funds to engage in certain trading strategies. Eventually, during the "late trading" imbroglio, the hedge funds captured the attention of the SEC, the New York Attorney General, and other agencies. The agencies conducted investigations, and Law Firm represented Clients during the investigations. The investigations went badly, and Clients were forced out of business costing them millions of dollars. Clients sued Law Firm, and in this opinion the court granted most of Law Firm's motion to dismiss. However, the court denied the motion as to Law Firm's alleged conflict of interest. Here is the court's characterization of Law Firm's conduct, which the court held stated a cause of action:

Plaintiffs allege that [Law Firm] fraudulently failed to advise plaintiffs of the inherent and unwaivable nature of the conflicts of interest, and intentionally and purposefully acted to place its own interests above those of plaintiffs by, among other things, purposefully omitting to present and "sweep[ing] . . . under the rug" the advice of counsel defense, withholding evidence, waiving plaintiffs' privilege, and advising plaintiffs to do things, and make compromises that were not in plaintiffs' best interest, all in order to avoid being brought into question for its own participation in the underlying transactions.

Seven days after *Veras* was decided, the following appeared: *Brodie v. U.S. Dept. of Justice*, 2007 U.S. Dist. LEXIS 75191 (E.D. Pa. Oct. 4, 2007). This opinion really dealt with whether litigants could compel attendance at a deposition of an Assistant United States Attorney in a state court legal malpractice action, so the underlying facts are not at all well developed in the opinion. Certainly, no facts have yet been developed that the law firm in question ("Law Firm") did anything at all improper. According to this opinion, Law Firm had advised Clients on the Trading with the Enemy Act ("the Act"). Later, the United States Attorney charged Clients with violating the Act and regulations under the Act. Law Firm commenced defending the criminal case and remained in that case until two weeks before trial. A jury convicted three of the Clients. One was ultimately exonerated, and two pleaded guilty to one count each.

Clients sued Law Firm for malpractice in state court, including Law Firm's conduct up until it withdrew from the criminal case. The complaint was not fully described in this opinion, but one might infer that Clients are complaining that Law Firm first advised Clients that they were not violating the Act, and then chose to defend the criminal proceeding that related to their advice.

Another event may also explain the conflict-of-interest claim. During the criminal proceeding an Assistant United States Attorney assigned to the case had an allegedly improper conversation with her husband, a lawyer at Law Firm, about the case. As a result of that conversation the court removed the wife from the case. It was shortly after that ruling that Law Firm withdrew from the criminal case.

Conclusion: Do these cases, and the unnamed cases mentioned above, which settled under the radar screen, mean that Law Firm should never take on the litigation arising out of its earlier work? Not at all. Malpractice insurance professionals recommend that, in this scenario, objective partners (not the partners involved in the underlying work) do a careful analysis of what the law firm might have done in the underlying work. At one extreme, in some cases they will conclude that the firm simply cannot proceed. At the other extreme the dispute may have nothing whatever to do with the law firm's underlying work, and the law firm may proceed. In between the extremes other measures may be appropriate, such as sending the client to other counsel for advice as to whether the law firm can continue. Of course, law firms in these situations must also be mindful of their possible duty of disclosure to their clients under their state's version of Model Rule 1.4.

Conflicts of Interest – Representing Both Sides in Transaction

A wants to sell his business to B. A and B happen to have the same lawyer ("Lawyer"). They ask Lawyer to handle both sides of the sale because they trust Lawyer and they want to save legal fees. May Lawyer proceed?

The Rules. ABA Model Rule 1.7, the principal conflict of interest rule, does not address this in specific terms but suggests that if Lawyer believes she can do a good job for both parties and gets a waiver from both parties, Lawyer can proceed. Comments [26]-[33] to Rule 1.7 attempt to be more specific about multiple representations, but do not help much. The Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York, in its Opinion 2001-2 (April 2001) discusses the issue in considerably more detail, but it concludes that whether the lawyer can proceed depends on the circumstances.

Waivers. Some transaction conflicts simply cannot be waived. The average good business lawyer will have a pretty good nose for transactions that are simply too difficult for joint representation. There may be too many contentious issues to be negotiated, which the parties cannot resolve without their own lawyers. In a few states, rules have evolved regarding certain types of transactions. For example, in New Jersey the same lawyer cannot be on both sides of a commercial real estate sale, even with waivers, if the

transaction is “complex,” *Baldassarre v. Butler*, 625 A.2d 458, 467 (N.J. 1993). Few states have decisions or rules that specific, but lawyers wishing to represent both sides of a transaction had better know what is expected in relevant jurisdictions.

Client Confidences. A lawyer representing more than one client in a transaction should obtain a written understanding up front, typically in the waiver document, as to the lawyer’s rights and obligations regarding client confidences. On the one hand the lawyer must protect each client’s confidences (Model Rule 1.6). On the other hand, the lawyer must keep each client informed about what the client needs to know to make decisions regarding the transaction (Model Rule 1.4). As mentioned in the above discussion on waivers, most ethics experts believe that a waiver or joint representation agreement should provide that the lawyer will not keep one client’s secret from other clients if the secret is relevant to the representation.

Conflicts of Interest – Contractual Limitations on Lawyer Liability

As transactions get ever bigger, law firms are concerned that their potential liability could far exceed their insurance coverage. For example, it would not be unusual for a U.S. law firm with insurance coverage of \$150 million per occurrence to handle transactions worth billions of dollars. This exposure is complicated by the increasing practice of clients asking for “due diligence reports” on certain aspects of transactions. These reports may be relied upon by other parties to the transaction, who that are not clients, including the myriad of people and entities providing financing for the transaction. We will first discuss liability to clients, followed by a brief discussion of non-clients.

Clients. One thought is that a law firm might ask its client to agree to a cap on the law firm’s liability in a given transaction. Presumably, the cap would be equal to, or within, the law firm’s malpractice coverage.

ABA Model Rule 1.8(h) provides as follows:

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer’s liability to a client for malpractice *unless the client is independently represented in making the agreement*; . . . (Italics, ours. We shall refer to the italicized clause as the “unless clause.”)

Thus, in a state with this rule, if the law firm asks the client to consult with other counsel about signing such an agreement, the agreement should not be unethical. Presumably, the client’s inside counsel, where available, could serve this function. Approximately forty states have the “unless clause,” or something close to it. Approximately ten states have an outright prohibition - that is, no “unless clause.” Unfortunately for national law firms, among the ten are California, the District of Columbia, and New York. At a recent meeting of the Committee on Professional Responsibility of the ABA Business Law Section, a leading ethics and lawyer liability expert stated that the choice of law rules are

complex enough that a law firm with lawyers admitted in those three jurisdictions could never be sure that the limitation on liability would be effective.

Non-Clients. Let's discuss a transaction in which the law firm is asked to provide its client with a "due diligence report" on some aspect of the transaction. We are told that other parties to the transaction, including institutions providing financing, regularly require that they be provided such reports, in part so that they do not have to pay counsel to do the same due diligence. That raises at least two issues: (1) can the law firm ethically obtain a limitation of liability (or cap) from these non-clients,?; and (2) assuming such an agreement is ethical, as a contractual matter, how can the law firm do this?

We will dispense with the second question first, by saying that we do not know. Certainly obtaining a signed, written agreement from a non-client specifying a cap on the law firm's liability would seem to do the trick. Some have suggested that merely stating in the report that anyone other than the client relying on the report is deemed to have agreed to a cap would be effective. We have no confidence that such a "self-executing" cap would be effective. Nor, do we believe that a law firm can, with confidence, rely upon a statement within the report that only the client can rely on the report. Those are large subjects, outside the purview of this paper and for another day.

What we can say with some confidence is that a lawyer may *ethically* ask a *non-client* to agree to a limitation of liability. First, note that the prohibition contained in Model Rule 1.8(h) pertains to clients. It says nothing about non-clients. Nor, are we aware of any other ethics rule that prohibits an agreement limiting a lawyer's liability to a non-client. Thus, one is left with contract (and other) issues, including those mentioned in the prior paragraph.

Disclaimer: one or more states may have prohibitions in their ethics rules or laws that of which we are not aware; and, this discussion does not cover other laws or regulations that may impact affect the validity of liability caps, including, but not limited to, tort law.

Conflicts of Interest – Serving on Boards of Clients

There can be obvious advantages for a lawyer to sit on the board of a corporate client, particularly if the client is a large, successful, respected entity. In such a case it is likely the other board members are successful and powerful people who can be sources of much business for the lawyer/director's law firm.

Legal ethics rules contain no general prohibition of the practice of serving on clients' boards. Comment [35] to ABA Model Rule 1.7 discusses the practice in the most general way. It includes the following:

If there is a material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise.

We are not aware of any state ethics rule that is more restrictive than the Model Rules on the practice of lawyers sitting on boards of clients. The Restatement (Third) of the Law Governing Lawyers does not purport to condemn the practice either, § 135, cmts. d and e, nor does the ABA Ethics Committee in its treatment of the subject at Formal Op. 98-410 (1998). State and local ethics opinions, while urging caution, recognize the propriety of lawyers sitting on boards of clients. *See, e.g.*, Association of the Bar of the City of New York, Committee on Professional and Judicial Ethics, Formal Op. 1988-5 (1988) (in the context of a lawyer/tenant serving on a cooperative board). (Accountants enjoy no such flexibility. The Code of Professional Conduct of the American Institute of CPAs declares that a member's independence is "impaired" if the member sits on the board of a client. *See* Interpretation 101-1(C)(1).)

Attorney-Client Privilege. The privilege is important in this context. There will always be a danger that a court will hold that the lawyer's communications with other board members or management were while she was wearing her "director hat" and not her "lawyer hat," and that the communications are discoverable in litigation. *See, e.g.*, *Deutsch v. Cogan*, 580 A.2d 100 (Del. Ch. 1990). At least one state bar ethics committee has opined that a lawyer asked to be a director must fully advise the client of this danger. New York State Bar Association, Committee on Professional Ethics, Op. 589 (1988).

Lawyer Malpractice Insurance Coverage. Insurance underwriters look askance at lawyers serving on boards of clients. As a result, malpractice insurance policies vary wildly in how they treat the practice. At one extreme, policies provide that whenever a lawyer sits on a board, the lawyer and the lawyer's firm have no coverage whatsoever in connection with that client. Less restrictive policies will provide coverage where the lawyer was acting as a lawyer (but not as a director). Determining whether a lawyer is acting as a lawyer or as a director can be highly contentious. Lawyers who wish to serve on boards (and their firms) must review their policies with great care to know what is covered and what is not. ABA Model Rule 1.4 provides that lawyers must keep clients informed about what they need to know to make decisions about the representation. The possibility that board service could deprive the law firm of coverage is something the client needs to know. In recognition of the coverage issues and some of the problems firms have had with lawyer/directors, law firms are regulating (in some cases, prohibiting) the practice as never before. Susan Kostal, *Board to Pieces*, A.B.A.J. 12 (June 2006).

More on Liability. In either an enforcement or liability context, courts have for many years held that directors who are also lawyers are held to a higher standard in what they know or should know about company matters. *See, e.g.*, *Blakely v. Lisac*, 357 F. Supp. 255 (D. Ore. 1972); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968); *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989) (lawyer/director a "controlling person under § 20(a) of the Securities Exchange Act of 1934).

Other "Unintended Consequences." A lawyer/director may not be able to try a case on behalf of the client, especially where he may be a witness. *Harrison v. Keystone Coca-Cola Bottling Co.*, 428 F. Supp. 149 (M.D. Pa. 1977). In a trade secret context, a lawyer/director handling case may not be able to see certain of the other side's

confidential documents. *Norbrook Laboratories, Ltd. v. G.C. Hanford Mfg. Co.*, 2003 U.S. Dist. LEXIS 6851 (N.D.N.Y. April 24, 2003). A law firm cannot be adverse to an entity where a lawyer in the firm had been on the board. See e.g., *Berry Saline Mem. Hosp.*, 907 S.W.2d 736 (Ark. 1995).

Representative Law Reviews. Bethany Smith, Note, *Sitting on vs. not Sitting on your Client's Board of Directors*, 15 Geo. J. Legal Ethics 597 (2002); *The Lawyer as Director of a Client*, 57 Bus. Law. 387 (November 2001); Stephen M. Zaloom, *Legal Status of the Lawyer-Director: Avoiding Ethical Misconduct*, 8 U. Miami Bus. L. Rev. 229 (2000).

Conflicts of Interest – Doing Business with Clients; Taking Securities in Lieu of Fees

Suppose a lawyer wishes to purchase a house from a client or wants to start a non-law business in partnership with a client – a saloon, perhaps. Or, suppose a lawyer wants to take securities from a client in lieu of fees. The analysis starts with ABA Model Rule 1.8(a), of which every state has a version. That rule has three important provisions. First, it provides that the transaction must be “fair and reasonable” to the client. Second, the lawyer must tell the client in writing that it would be a good idea for the client to check with another lawyer on the advisability of the transaction. Third, the client must sign a written consent containing the essential terms of the transaction and the lawyer’s role in it.

Probably the most dramatic illustration of a lawyer’s failure to follow Rule 1.8(a) was in *Passante v. McWilliams*, 62 Cal. Rptr. 2d 298 (Cal. App. 1997). A corporate client, promised to give a lawyer a small percentage of its stock in return for the lawyer having just found badly needed financing for the corporation. At that time the stock was worth very little. Several years later, when the lawyer attempted to obtain the stock, it had become worth some \$32 million. The California Appellate Court ruled that the lawyer was not entitled to the stock because of, in part, the lawyer’s violation of California’s version of Model Rule 1.8(a) (Cal. Rule 3-300).

More recently, in *Goldston v. Bandwidth Tech. Corp.*, 2008 WL 2445496 (N.Y. App. June 19, 2008), the lawyer fared better. He had a retainer agreement to provide corporate services to a high tech company in exchange for 2% of the company’s stock, then worth, perhaps, some \$40,000. According to press reports, one of the appellate briefs disclosed that the 2% had become worth more than \$7 million. In the above opinion the Appellate Division affirmed the trial court’s finding that the lawyer was entitled to the stock. A principal issue was whether the company’s president had authority to make the agreement (he did). There were other issues as well. There was no discussion whatever of New York’s version of Model Rule 1.8(a) (N.Y. DR 5-104).

Note that in *Passante* the promise of stock came during the lawyer-client relationship. In *Goldston* the retainer agreement was negotiated at the outset of the representation. While the court in *Goldston* did not discuss that distinction, the different treatment in the two cases comports with those cases that deal with fee changes that occur after the

representation has commenced (sometimes referred to as “mid-stream fee changes”). Courts are generally hostile to mid-stream fee changes, and they increasingly invoke Model Rule 1.8(a) specifically in evaluating whether such changes are enforceable. See, e.g., *Valley/50th Ave., L.L.C. v. Stewart*, 153 P.3d 186 (Wash. 2007).

What about taking securities from clients in lieu of fees? The ABA Ethics Committee has addressed this issue in its Formal Opinion 00-418 (2000) (hereinafter, “ABA Op. 00-418”), “Acquiring Ownership in a Client in Connection with Performing Legal Services.” It says that such arrangements are not per se unethical, but says that lawyers taking client securities must comply with Model Rule 1.8(a). That means the arrangement must be in writing, the client be afforded a reasonable opportunity to consult with other counsel, the client's consent to the arrangement be in writing, and the terms be “fair and reasonable” to the client. The opinion discusses the interplay of the “fair and reasonable” requirement of Rule 1.8(a) and the requirement of Model Rule 1.5(a) that fees be “reasonable.” It also deals with the need to disclose possible conflicts to the client and the role of Model Rule 1.7(b) (now 1.7(a)(2)), which relates to conflicts of interest and the lawyer’s interests.

Opinion 2000-3 (2000) of the Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York (hereinafter, “N.Y. City Bar Op. 2000-3), which was rendered soon after ABA Op. 00-418, basically tracks that opinion. In brief summary, it is slightly more lenient than ABA Op. 00-418. It says that the lawyer does not have to comply with N.Y. DR 5-104(A) (N.Y.'s version of Model Rule 1.8(a)), unless the client is relying upon the advice of the lawyer with respect to the fee transaction itself. Thus, the Committee concludes, there may be instances in which a lawyer takes stock in lieu of fees where it would be appropriate to treat the arrangement as any other fee arrangement. The sophistication of the client and complexity of the transaction will obviously play a role in whether this is the case. In other respects, N.Y. City Bar Op. 2000-3 is comparable to ABA Op. 00-418.

The District of Columbia Bar Legal Ethics Committee Opinion 300 (2000) mentions ABA Op. 00-418 and N.Y. City Bar Op. 2000-3, only in a footnote, but states that Op. 300 reaches the same conclusions as those two opinions. Actually, unlike N.Y. City Bar Op. 2000-3, Op. 300 does not discuss situations in which such an arrangement might not be subject to Rule 1.8(a) or its New York counterpart, DR 5-104.

Negotiation Ethics

We will limit this discussion to the American Bar Association (“ABA”) Model Rules of Professional Conduct. In most cases the states have rules identical to, or very similar to, the Model Rules. Where there is disparity, we will point it out.

Lawyer Conduct. The most important rule on truthfulness is Model Rule 4.1(a). It says a lawyer may not lie to a third person. The rule contains no exception for negotiations. Model Rule 8.4(c) overlaps with Rule 4.1(a) in providing that a lawyer may not engage in “dishonesty, fraud, deceit or misrepresentation.” See, too, The Restatement (Third) of the Law Governing Lawyers § 98, cmt. c (2000), and Geoffrey C. Hazard, Jr. & W. William

Hodes, *The Law of Lawyering* § 65.5 (3d ed. 2001). As to lying to non-clients in the context of a transaction governed by federal securities law, see *Thompson v. Paul*, 547 F.3d 1055 (9th Cir. 2008).

In April 2006 the ABA Ethics Committee issued its Formal Opinion 06-439, entitled, “Lawyer’s Obligation of Truthfulness When Representing a Client in Negotiation: Application to Caucused Mediation.” It repeats the obvious that a lawyer may not lie. The opinion does recognize that lawyers may be expected to “puff” as to certain issues. For example, a lawyer may say that his witnesses are more credible than the other side’s. What the lawyer may not say is that he has five witnesses to an event when he really only has one.

Client Conduct. The situation gets trickier when, during negotiations, it is the client who is lying. Model Rule 1.2(d) provides that a lawyer may not assist the client in committing a crime or fraud. All states have such a rule. Moreover, Model Rule 1.16(a)(1) provides that the lawyer must withdraw from the representation where to continue would cause a violation of a rule.

Suppose a lawyer is aware that her client is lying to the other side in a negotiation. We have just seen that the lawyer cannot continue if the client persists. Under what circumstances may or must the lawyer warn others of the client’s intentions? Model Rule 1.6, the confidentiality rule, plays a role. Rule 1.6(b)(2)&(3) now allows a lawyer to “blow the whistle” to prevent the client from committing a fraud on another or to rectify a fraud that has already occurred. Most states have comparable exceptions to their confidentiality rules. A few states provide that a lawyer *must* report client fraud.

Now return to Rule 4.1. Recall that Rule 4.1(a) says that a lawyer may not lie. Rule 4.1(b), however, says a lawyer must disclose a client’s lie when it is “necessary to avoid assisting a criminal or fraudulent act by a client.” That sentence ends with “unless disclosure is prohibited by Rule 1.6.” Recall, though, that most states have provisions in their versions of Rule 1.6 that permit disclosure. Thus, in many states, the lawyer may have the obligation to blow the whistle on a client.

Caution: the interplay of these rules is extraordinarily complex, and the consequences of acting under them can be enormous. The average good lawyer needs to consult with an ethics expert before deciding on a strategy to deal with suspected client fraud.

Conduct within an Organization. Where the client is an organization, Model Rule 1.13 (“Organization as Client”) is implicated. Assume that the lawyer and an officer of the client are negotiating a transaction with another party. Assume further that the officer is making claims that the lawyer knows (or strongly suspects) are not true. The lawyer should first attempt to straighten out the officer. Failing that, Rule 1.13(b) provides that the lawyer must go over the officer’s head (“climb the ladder”) even to the board of directors, if necessary. Prior to 2003 Model Rule 1.13 did not make climbing the ladder mandatory, nor did the rules of most states. Subsequent to the ABA changes in 2003 many states have amended their versions of Rule 1.13 to make climbing the ladder mandatory.

As to public companies, the SEC has adopted 17 C.F.R Part 205, which, among other things, requires, under some circumstances, the lawyer to climb the organizational ladder. To illustrate the complexity of the SEC requirements, many well-run law firms have committees of lawyers devoted to seeing that the regulation is followed and providing training to securities lawyers on the regulation.

Cases. *Sheppard v. River Valley Fitness One, L.P.*, 428 F.3d 1 (1st Cir. 2005) (lawyer sanctioned for making misrepresentations during settlement negotiations.); *Ausherman v. Bank of America Corp.*, 212 F. Supp. 2d 435 (D. Md. 2002) (lawyer referred to court's disciplinary committee for telling lie during settlement negotiations); *Makins v. District of Columbia*, 861 A.2d 590 (D.C. 2004) (settlement not enforceable where plaintiff's lawyer failed to obtain plaintiff's concurrence); *Hansen v. Anderson, Wilmarth & Van Der Maaten*, 630 N.W.2d 818 (Iowa 2001) (lawyer who prepared bogus transaction documents liable to non-client); *Shafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone*, 131 Cal. Rpter. 2d 777 (Cal. App. 2003) (lawyer who lied about insurance coverage opinion could be liable to non-client for fraud); *Jeska v. Mulhall*, 693 P.2d 1335 (Ore. App. 1985) (buyer of real estate could sue seller's lawyer for fraud during negotiations); *Slotkin v. Citizens Cas. Co. of N.Y.*, 614 F.2d 301 (2d Cir. 1979), *cert denied*, 449 U.S. 981 (1980) (allowed suit for fraud where lawyer misrepresented the amount of available insurance coverage); *Kentucky Bar Ass'n v. Geisler*, 938 S.W.2d 578 (Ky. 1997) (lawyer disciplined for failing to reveal death of client during settlement negotiations); *In re Warner*, 851 So. 2d 1029 (La. 2003) (same); *Toledo Bar Ass'n v. Fell*, 364 N.E.2d 872 (Ohio 1977) (same); *Virzi v. Grand Trunk Warehouse & Cold Storage Co.*, 571 F. Supp. 507 (E.D. Mich. 1983) (failure to reveal death of client grounds for setting aside settlement agreement); *Spaulding v. Zimmerman*, 116 N.W.2d 825 (Minn. 1962) (failure to disclose client's medical condition grounds for setting aside settlement agreement).

Law Reviews. Reed Elizabeth Loder, *Moral Truthseeking and the Virtuous Negotiator*, 8 Geo. J. Legal Ethics 45 (1994); Alvin B. Rubin, *A Causerie on Lawyers' Ethics in Negotiation*, 35 La. L. Rev. 577 (1975); Michael H. Rubin, *The Ethics of Negotiation: Are There Any?*, 56 La. L. Rev. 447 (1995); Barry R. Temkin, *Misrepresentation by Omission in Settlement Negotiations: Should There Be a Silent Safe Harbor?*, 18 Geo. J. Legal Ethics 179 (2004); James J. White, *Machiavelli and the Bar: Ethical Limitations on Lying in Negotiation*, 1980 Am. B. Found. Res. J. 921 (1980); Charles B. Craver, *Negotiation Ethics: How to Be Deceptive Without Being Dishonest/How to Be Assertive Without Being Offensive*, 38 S. Tex. L. Rev. 713 (1997); Van M. Pounds, *Promoting Truthfulness in Negotiation: A Mindful Approach*, 40 Willamette L. Rev. 181 (2004); James J. Alfini, *Settlement Ethics and Lawyering in ADR Proceedings: A Proposal to Revise Rule 4.1*, 19 N. Ill. U. L. Rev. 255 (1999).

Confidentiality and Client Fraud

Model Rule 1.2(d) provides as follows:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

What is knowledge? Model Rule 1.0(f) provides that knowledge can be “inferred from the circumstances.” The vagueness of the definition should be a red flag to a lawyer who “smells a rat” in connection with what a client is telling the lawyer or other parties to a transaction.

Example: a lawyer learns that a client is not being truthful in transaction documents or in statements to other parties. The lawyer confronts the client and instructs the client to “knock it off.” The client refuses. Model Rule 1.2(d) provides the lawyer cannot continue. Model Rule 1.16(a)(1) provides that the lawyer must withdraw from the representation.

Disclosure of client fraud to others. Rules 1.6(b)(2)&(3) provide as follows:

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

* * * *

2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

Most states have an exception to confidentiality that is the same or nearly the same as the provisions quoted just above, see the chart with state-by-state analysis at Thomas D. Morgan & Ronald D. Rotunda, 2008 Selected Standards on Professional Responsibility 149-164 (2008).

Most states' rules do not command the lawyer to reveal client fraud to others; they permit disclosure. One must, however, be wary of Model Rule 4.1(b), which provides:

In the course of representing a client a lawyer shall not knowingly:

* * * *

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

Suppose a lawyer is sitting in on a negotiation with her client and the lawyer and client

on the other side. The lawyer hears the client make a misrepresentation. The lawyer drags the client out of the meeting room and privately admonishes the client to set the record straight – however that can gracefully be done. The client refuses. We know that Model Rules 1.2(d) and 1.16(a)(1) require the lawyer to withdraw. But, what about telling the other side about the misrepresentation? Model Rule 4.1(b) would seem to convert permissive disclosure under the exceptions to Model Rule 1.6 to mandatory disclosure. While we are not aware of any case citing Model Rule 4.1(b) in exactly this context, we have long been intrigued by the reach of that rule in connection with misrepresentations being made by clients leading up to the closing of transactions.

Role of privilege. The attorney-client privilege can be lost where a party to a transaction can show that during lawyer-client communications the client was committing, or planning, a crime or fraud. The mischief to lawyers or law firms that the loss of privilege can cause is enormous. Not only will the misconduct of clients be documented, but also the complicity (or seeming complicity) of the law firm in the misconduct. Every memorandum and E-mail within the law firm will be fair game for prosecutors, regulators, and plaintiffs' class action lawyers.

Confidentiality vs. Attorney-Client Privilege

Model Rule 1.6 provides in part:

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

Note that the rule protects information whether or not the lawyer got it from the client or some other source. The rule also provides that a lawyer may reveal client information where the client impliedly agrees. Thus, where it is obvious that a lawyer must make certain disclosures in an opinion to the other side in order to comply with transaction documents, the lawyer may do so.

Attorney-Client Privilege. The privilege is different from the duty of confidentiality in several important respects. First, the privilege only applies to whether one side in litigation can compel a lawyer for a party to reveal the lawyer's communications with the lawyer's client. The privilege does not "seal the lawyer's lips," in this respect; Model Rule 1.6 does. *Adams v. Franklin*, 924 A.2d 993 (D.C. App. 2007). Model Rule 1.6 seals the lawyer's lips whether or not there is litigation. Thus, whether a lawyer can reveal client information in an opinion depends not upon the privilege but upon the lawyer's duties of confidentiality under the ethics rules.

Attorney-Client Privilege/Work Product – Recent Developments

Courts have been busy issuing opinions on the attorney-client privilege (“privilege”) and work product immunity (“work product”) that impact the work of business lawyers. Below we discuss several that are both recent and significant.

Waiver of Privilege by Special Committee of Board. One recent such opinion is Chancellor Chandler’s letter ruling at *Ryan v. Gifford*, No. 2213-CC, 2007 Del. Ch. LEXIS 168 (Del. Ch. Nov. 30, 2007). This is a shareholders’ derivative action alleging backdating of options by management of Maxim Integrated Products, Inc. (“Maxim”). While the letter contains a number of unremarkable discovery rulings, one that stands out is the court’s ruling on the communications between a special committee of the board of Maxim, appointed to investigate the backdating allegations, and the law firm representing the special committee (“Law Firm”). The court acknowledged that the special committee was a client of Law Firm for privilege purposes, but because Law Firm presented the report of its investigation to the full board of Maxim, that privilege was waived. The court said the scope of the waiver was broad and ordered that almost all material developed by Law Firm during the investigation be turned over to the plaintiffs.

Waiver by Sharing with Non-Lawyer Corporate Employees. *In re Vioxx Products Liab. Lit.*, 501 F. Supp. 2d 789 (E.D. La. 2007), is a multidistrict proceeding involving drug product liability claims. The opinion deals with manufacturers’ claims that approximately 30,000 documents sought in discovery were protected by privilege, work product, or both. The court appointed a special master, a law professor who is an expert in evidence and privilege/work product. The master issued a report, and in this opinion the court affirmed the master. Much of the master’s report dealt with memoranda and E-mails that were shared with in-house lawyers, outside lawyers, and significantly, with non-lawyer employees of the manufacturers. We will not set forth the master’s analysis of each type of communication, which are lengthy and quoted in the opinion. We do suggest that any lawyer concerned about the distribution of legal-related documents by, or to, non-lawyer employees will find this opinion educational.

Privilege, Work Product, and Corporate Families. *In re Teleglobe Communications Corp.*, 493 F.3d 345 (3d Cir. 2007) is a thirty-three page “mini-treatise,” complete with Table of Contents, on the application of privilege and work product in the corporate family context, where members of the family fall out of alignment. Included are discussions of the co-client rule, the adverse litigation exception to that rule, the distinction between joint representation and common interest, and much more. It is easy to read and a must for corporate lawyers representing multiple corporate family members.

Selective Waiver Rejected. Courts are almost uniform in holding that if a person reveals privileged material to an administrative agency, even under a confidentiality agreement, that person waives the privilege as to law enforcement personnel and civil litigants. A recent such case is *In re Initial Pub. Offering Securities Lit.*, 249 F.R.D. 457 (S.D.N.Y. 2008).

Communicating with Represented Persons

ABA Model Rule 4.2 says that a lawyer may not communicate with the client on the other side without the permission of the other side's lawyer. Generally speaking, the "party," in the case of organizations is a relatively high-ranking employee or an employee whose conduct was the subject of the controversy. In the case of litigation, violation of the rule could get a lawyer disqualified. In the context of a transaction, the consequences of a violation seem to be less severe.

Suppose, during a negotiation, that you strongly suspect that the opposing lawyer is not conveying your offers. May you call the other party directly to find out? No. May you prompt your client to do so? There is no rule prohibiting clients from contacting one another directly. Older wisdom was that lawyers could not discuss with their clients the possibility of such communications. That has softened. For example in Formal Opinion 92-362 (2002) the ABA Ethics Committee held that a lawyer could ethically discuss with her client the possibility of talking to the other party in just such a circumstance. More recently, the Committee held that a lawyer could communicate with an in-house lawyer for a party, even though the party was represented by an outside lawyer, Formal Opinion 06-443 (2006). These opinions do not have the force of law, so you should consult with the rules and opinions in your jurisdiction before conducting either type of communication.

We understand that Rule 4.2 is almost routinely violated in some major cities in the transactional context, particularly where the person contacted, or, just as frequently, doing the contacting, is highly sophisticated. We have not done the research, but in following ethics developments closely over the past twenty years we have not heard of a disciplinary proceeding against a lawyer who contacted a sophisticated corporate employee of the other side in a transactional (i.e., non-litigation) context.
