WALKING THE ETHICAL LINE

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LOS ANGELES
DECEMBER 2007

I. Ethical Standards and Civil Liability

A. Sources of Law Governing Ethical Standards for Attorneys in California

1. California Rules of Professional Conduct ("CRPC").

   Promulgated by the State Bar under its delegated power subject to Supreme Court approval. *Howard v. Babcock* (1993) 6 Cal. 4th 409, 418.

2. Rules of Professional Conduct in Other Jurisdictions

   California attorneys State Bar members practicing in another jurisdiction may be required to follow rules of professional conduct in that jurisdiction. Discipline imposed upon a California State Bar member by a federal court or other state's court or disciplinary board for professional misconduct outside California may be ground for discipline in this state. Bus. & Prof. Code § 6049.1.

3. State Bar Act (Bus. & Prof. Code § 6000 et seq.)

4. California Rules of Court

   These rules include rules regulating the admission to practice law in California, State Bar Rules of Procedure, disciplinary proceedings, and specialized rules such as client security funds.

5. Other Rules/Statutes Governing Lawyers

   Other rules and statutes (primarily directed at lawyers in particular fields of practice) also regulate attorney conduct and professional responsibility. E.g. the Sarbanes–Oxley Act and rules promulgated thereunder setting forth standards of conduct for attorneys "appearing and practicing" before the SEC "in the representation of an issuer.

6. Federal court rules

   Practice in federal court is governed entirely by federal law and federal court rules of admission and professional conduct although

these often incorporate the CRPC and State Bar Act. E.g., Local Rule 83–3.1.2 (Central District of California).

7. Bar Association Ethics Opinions

The State Bar and local bar associations issue written ethics opinions. These opinions are not binding upon the courts or any disciplinary body; however, they are frequently cited in court opinions for their analyses and conclusions, and can be used by practitioners for guidance on specific ethical issues. See *State Comp. Ins. Fund v. WPS, Inc.* (1999) 70 Cal.App. 4th 644, 656. Ethics opinions from other jurisdictions may be considered for guidance on proper professional conduct (but they are not binding on California attorneys)

8. ABA

(a) ABA Model Rules

California has not adopted the ABA Model Rules. *In State Comp. Ins. Fund v. WPS*, Inc, 70 Cal.App.4th 644, 655, the court held that the ABA Model Rules "do not establish ethical standards in California ... and have no legal force of their own." see also Colyer v. Smith (C.D. Cal. 1999) 50 F.Supp.2d 966, 972 (Attorneys practicing before federal courts in Calif. Central District have no duty to comply with ABA Model Code and Rule requirements re reporting ethical violations by fellow attorneys because Central District has adopted the CRPC, not the ABA Model Code or Rules.) However, the ABA Model Rules may be considered as guidance, in the absence of contrary authority or public policy in California.

(b) ABA Ethics Opinions

ABA formal ethics opinions may provide guidance even though they are not binding in the absence of contrary authority or public policy. See CRPC 1-100(A).

9. Restatement 3d Law Governing Lawyers

Restatements of the Law are treatises published by the American Law Institute. Founded in 1923, the American Law Institute has a membership consisting of judges, practicing lawyers, and legal scholars from all areas of the United States as well as some foreign countries. The Restatement 3d of the Law Governing Lawyers, while not binding on California lawyers, is also considered persuasive guidance where no California standard of conduct exists. See *Dieter v. Regents of Univ. of Calif.* (E.D. Cal. 1997) 963 F.Supp. 908, 910,-

B. Selected Ethical Standards

1. Professional Expertise and Competence: What skills must the attorney possess?

(a) CRPC 3-110—attorneys owe clients a duty of competence

(b) Advising client about organizing/operating a business entity requires competence in the areas of business organizations as well as many other areas of law. Often this requires familiarity with the following areas: formation and dissolution of the LLC; state and federal securities regulations; federal, state and local taxation; real property transactions and possibly intellectual property.

(c) If attorney lacks sufficient learning and skill when consulted by client, it is ethical to perform the services if he/she acquires the necessary skills before performance is required. CRPC 3-110(c)

(d) Attorney has duty to consult a specialist if a reasonable practitioner would do so under the circumstances. Performance of non-specialist who fails to consult specialist will be subject to review under the same standards as those applicable to a specialist in that area. *Horne v. Peckham* (1979) 97 Cal. App. 3d 404, overruled on other grounds, ITT Small Business Finance Corp. (1994) 9 Cal.4th 245. (In a case of first impression, the Court of appeal approved a jury instruction based upon that used in medical malpractice cases which stated, “"It is the duty of an attorney who is a general practitioner to refer his client to a specialist or recommend the assistance of a specialist if under the circumstances a reasonably careful and skillful practitioner would do so. If he fails to perform that duty and undertakes to perform professional services without the aid of a specialist, it is his further duty to have the knowledge and skill ordinarily possessed, and exercise the care and skill ordinarily used by specialists in good standing in the same or similar locality and under the same circumstances. Failure to perform any such duty is negligence.").

(e) Practitioner may also be subject to discipline for failure to consult with a specialist if he/she lacks necessary knowledge or experience. *Lewis v. State Bar* (1981) 28 Cal. 3d 683. (Attorney was disciplined where the disciplinary board hearing panel found that petitioner's performance in administering an estate constituted a violation of a predecessor to Rule 3-110 in

that, knowing that he did not possess sufficient skill in probate matters, he failed to associate or consult another lawyer who did possess the requisite learning and skill, and that he willfully failed and refused to perform all of the services for which he was retained.)

(f) In an emergency, where referral or consultation with another lawyer is impractical, the attorney may give limited advice or assistance in a matter in which he/she does not have the skill ordinarily required.

2. Rules Governing Sexual Relations with Client

CRPC 3-120 provides that with respect to sexual relations other than those between members and their spouses or ongoing consensual sexual relationships which predate the initiation of the lawyer-client relationship, a member shall not: (1) require or demand sexual relations with a client incident to or as a condition of any professional representation; or (2) employ coercion, intimidation, or undue influence in entering into sexual relations with a client; or (3) continue representation of a client with whom the member has sexual relations if such sexual relations cause the member to perform legal services incompetently in violation of CRPC 3-110. (Where a lawyer in a firm has sexual relations with a client but does not participate in the representation of that client, the lawyers in the firm shall not be subject to discipline under this rule solely because of the occurrence of such sexual relations.)

3. CRPC 3-210 re Advising the Violation of Law

(a) A member shall not advise the violation of any law, rule, or ruling of a tribunal unless the member believes in good faith that such law, rule, or ruling is invalid. A member may take appropriate steps in good faith to test the validity of any law, rule, or ruling of a tribunal.

(b) CRPC 3-210 is intended to apply not only to the prospective conduct of a client but also to the interaction between the member and client and to the specific legal service sought by the client from the member.

(c) Potential civil and criminal liability.

4. Communication/Responsiveness: How must the attorney communicate with the client?

(a) CRPC 3-500—attorneys must keep client reasonably informed about significant developments relating to the representation.

(b) Attorney should not be subject to discipline for failing to inform client of irrelevant or insignificant information. Bus. & Prof. Code § 6068.

C. Civil Liability

1. Failure to Provide Competent Representation as Basis for Civil Liability: Professional Negligence.

(a) Professional negligence most common cause of action (others may include breach of contract and breach of fiduciary duty—depending on the circumstances)

(b) Attorney's duty for purposes of malpractice is an objective "reasonable attorney" standard.

(i) Duty to have degree of learning and skill ordinarily possessed by attorneys of good standing, practicing in same or similar locality and under similar circumstances.

(ii) Duty to use care and skill ordinarily exercised in like cases by reputable members of profession practicing in same or similar locality and under similar circumstances, and to use reasonable diligence and best judgment in exercise of skill and accomplishment of his learning in an effort to accomplish best possible result for client.

(iii) Failure to perform any such duty is negligence. *Smith v. Lewis* (1975) 47 Cal. 3d 349.

(c) Harm to client is required element in malpractice action (harm not required in disciplinary proceedings).

2. Client Communication as a Means of Avoiding Civil Liability

(a) Communication/responsiveness required by rules

(b) Many problems resulting in civil liability could be avoided or at least mitigated by effective client communication

(c) See CRPC 3-500

II. The Role of the Attorney as Advisor in LLC Formation

A. Determining Whether Representation is Appropriate

1. An initial issue is whether the prospective client's needs fall within his or her areas of professional expertise.

2. As discussed above, the CRPC impose a duty of competence on attorneys.

3. Before representing a prospective client who wants advice on organizing and selecting a business entity, the attorney must have enough preliminary information to determine whether he or she can adequately represent the client.

4. The attorney should collect information regarding the identities, biographies and business affiliations of the principals and people that will have material relationships with the potential organization, a summary of the business plan, and trade names that will be used. This will also be useful for identifying any potential conflicts of interest before discussing any significant confidential information or giving any substantive legal advice.

B. Identifying the Client

1. Clearly identifying the client is necessary because the parties involved may have conflicting interests and the attorney must represent and protect the interests of the client, even if those interests are adverse to the interests of another party involved.

2. Attorney should make sure that the parties clearly understand the attorney's role in the formation of the entity, who the attorney actually represents, and what happens if the parties get into a dispute over the business at a later date.

C. Becoming Familiar with the Client's Business Plans

1. The attorney should become familiar with the client's business plans in order to properly advise the client as to the proper form of business entity.

2. Consider what form of business entities may be more appropriate, depending on the client's circumstances.

D. Advising the Client

1. The attorney often is required to advise the parties on the statutory scheme for formation, contract matters (i.e. buy-sell provisions), tax issues, and other potential securities issues.

2. Clients may also seek advice from the attorney on business issues. Be careful to make it clear to the client what role you are assuming.

III. Avoiding Conflicts of Interest

A. Conflicts among Parties

1. Overview

(a) Common for client to request attorney to organize/advise a business venture and to represent both entity and multiple participants with varying interests

(b) CRPC 3-310(c) makes it unethical for attorney to represent multiple parties with conflicting interests unless he/she has informed consent from each party

(c) Practitioner must determine whether possible or advisable to represent parties as group or whether conflicts require separate representation. If determined that interests generally the same, joint engagement can be accepted. If any potential conflict of interest, attorney must obtain written consent from each party. CRPC 3-310(c)(1).

2. Inherent Conflict in LLCs: Managers and Nonmanagers

(a) Inherent conflict exists between interests of members are active managers of the LLC and those who are passive members/investors.

(b) Managing members may seek compensation based on a share of profits and separate salaries/fees for specific services.

(c) Passive, non-managing members usually rely solely on a share of profits for return on their investment.

(d) Thus, different members of the LLC have interests that may be separate from or in conflict with the interests of other members of the LLC.

3. When Multiple Representation Is Inappropriate

(a) If multiple representation seems inappropriate, attorney may wish to represent only the entity and/or only one of the parties to the formation of the LLC.

(b) Inform all parties (including the one represented) of the following:

(i) Whom counsel will and will not represent in formation of the LLC;

(ii) Nature of existing and foreseeable (to extent appropriate) conflicts among participants;

(iii) That attorney cannot undertake to advise other parties or protect their interests and that if other parties want legal advice they must seek separate counsel; and

(iv) Proposed terms, if any, under which practitioner would represent entity itself (rather than the participants in the entity) upon completion of entity's organization.

(c) Attorney should have each party acknowledge in writing receipt of this information and understanding of the matters before proceeding with the engagement.

(d) Attorney must be on alert for possible conflicts throughout the representation

(e) If attorney initially deemed multiple representation appropriate, but interests later diverge or material conflict arises, attorney should again advise parties to obtain independent counsel, despite any prior consents from the parties.

(f) If clients' separate interests cannot be fairly represented, attorney may be required to discontinue any representation of the business entity unless such independent counsel is obtained. CRPC 3-310

B. Organization as Client

1. CRPC 3-600—Organization as Client

2. Professional Rules of Conduct state that when an attorney has an organization as a client, in a situation where the organization's management, investors, employees, members, or other constituents have interests that are or may become adverse to the organization, the attorney should explain the client's identity to the adverse party and limit his or her representation to the client's best interests. If it becomes clear that the client's interests and individual director's or manager's interests are adverse and illegal, the attorney may not disclose the information, but must resign from representation.

C. Conflicts between Practitioner and Client

1. Disclosure Requirements

(a) Attorney must not accept or continue representation of client without providing written disclosure to client if attorney:

(i) Has a legal, business, financial, professional, or personal relationship with a party in the same matter CRPC 3-310(B)(1), or

(ii) Knows or reasonably should know that the attorney previously had a legal, business, financial, professional or personal relationship with a party or witness in the same matter that would substantially affect its representation CRPC 3-310(B)(2).

(b) Attorney must not accept or continue representation of client without providing written disclosure to client if attorney:

(i) Has or had legal, business, financial, professional or personal relationship with another person or entity the attorney knows, or reasonably should know, would be affected substantially by resolution of the matter. CRPC 3-310(B)(3), or

(ii) Has or had legal, business, financial, or professional interest in the subject matter of the representation CRPC 3-310(B)(4).

(c) Conflicts can arise if attorney

(i) Invests in client's business;

(ii) Accepts an economic interest in the business in lieu of fees; or

(iii) Enters into transactions to provide goods or nonlegal services to a client.

(d) If attorney enters into a business transaction with a client, or knowingly acquires a pecuniary interest adverse to the client, the attorney must fully disclose the transaction in writing to the client, ascertain the fairness of its terms, advise the client to seek independent legal advice, provide the client with a reasonable opportunity to seek such advice, and obtain the client's informed written consent. (CRPC 3-300). Attorney may also need to disclose the transaction to the members of the LLC and obtain their informed written consent. An attorney should be cautious about providing legal advice to a client in whose business he/she has a financial stake due to the potential for many conflicts of interest.

2. Conflicts When Practitioner Serves as Both Counselor to and Officer of the Entity

(a) Attorneys may be asked to serve in managerial capacities in an LLC. This gives rise to many potential conflicts of interest.

(b) Attorney is serving the entity in dual roles, and his/her advise will not be truly independent. This creates a greater likelihood of material conflicts of interest.

(c) Attorneys are held to a higher standard of conduct in the managerial capacity than a non-attorney. Other members may find it difficult to distinguish legal advice from statements made as a manager in a business context.

(d) Economic benefits resulting from attorney's managerial role are subject to CRPC 3-300.

IV. Confidentiality—Information Derived from an Earlier Representation

A. The Duty of Confidentiality

1. Confidential Information of a Client. CRPC Rule 3-100 provides that:

(a) A member shall not reveal information protected from disclosure by Bus. & Prof. Code § 6068, subdivision (e)(1) without the informed consent of the client, or as provided in paragraph (B) of this rule.

(b) A member may, but is not required to, reveal confidential information relating to the representation of a client to the extent that the member reasonably believes the disclosure is necessary to prevent a criminal act that the member reasonably believes is likely to result in death of, or substantial bodily harm to, an individual.

(c) Before revealing confidential information to prevent a criminal act as provided in paragraph (B), a member shall, if reasonable under the circumstances:

(i) Make a good faith effort to persuade the client: (i) not to commit or to continue the criminal act or (ii) to pursue a course of conduct that will prevent the threatened death or substantial bodily harm; or do both (i) and (ii); and

(ii) Inform the client, at an appropriate time, of the member's ability or decision to reveal information as provided in paragraph (B).

(d) In revealing confidential information as provided in paragraph (B), the member's disclosure must be no more than is

necessary to prevent the criminal act, given the information known to the member at the time of the disclosure.

(e) A member who does not reveal information permitted by paragraph (B) does not violate this rule.

2. The discussion to the rule states that paragraph (A) relates to a member's obligations under Bus. & Prof. Code § 6068, subdivision (e)(1), which provides it is a duty of a member: "To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client." A member's duty to preserve the confidentiality of client information involves public policies of paramount importance. (*In Re Jordan* (1974) 12 Cal.3d 575, 580.

3. The duty of confidentiality is broader than attorney-client privilege. Compare Bus. & Prof. Code § 6068(3) and Evid. Code § 950.

B. Special Confidentiality Problems for the Business Lawyer

1. A transactional attorney must also give repeated attention to the problem of actual or potential conflicts of interest as new clients appear. For example, the initial client will probably tell the attorney about confidential business plans, personal goals and objectives, or other information that the client may not want disclosed to others. In a subsequent transaction, the confidential information disclosed by the original client may become a material fact that has to be disclosed to the potential new client in the new situation. Before agreeing to represent multiple clients in the new matter, the attorney should discuss these concerns with the original client and obtain the original client's informed, written consent, not just the informed, written consent of the new client.

2. If the attorney withdraws from representation and subsequently is offered the opportunity to represent another client in a transaction with the original client, the informed, written consent of the original client will have to be obtained if confidential information relevant to the new representation was obtained in the former representation. CRPC 3-310(E).

3. If multiple representation seems inappropriate for any reason, the attorney may wish to represent only the entity and/or one of the partners/members. The attorney should then inform all parties (including the party to be represented) of at least the following matters and:

(a). Whom counsel will and will not represent in the formation of the venture;

(b) The nature of existing, and to the extent appropriate, foreseeable conflicts of interest among the participants or between the attorney and the participants;

(c) That the attorney cannot undertake to advise the other parties or protect their interests and that, if the other parties wish legal advice, they should consult separate counsel; and

(d) The proposed terms, if any, under which the attorney would represent the entity itself (rather than the individual participants in the entity) on completion of the entity's organization.

(e) The attorney should consider proceeding with the engagement having each party should acknowledge in writing receipt of this information and understanding of these matters and provide waivers of the conflicts of interest.

C. Special Confidentiality Problems for the Business Lawyer

1. Where two ore more clients have retained or consulted a lawyer upon a matter of common interest, none of the, nor the successor in interest of any of them, may claim a privilege under this article as to a communication made in the course of that relationship when such communication is offered in a civil proceeding between one of such clients (or his successor in interest) and another of such clients (or his successor in interest). Evidence Code § 962