ORANGE COUNTY BAR ASSOCIATION

Formal Opinion 2011-02 (Performance of Legal and Director Services for a Company in Which the Attorney Has an Existing Investment)

Issue:

What professional responsibilities does a lawyer have upon considering or accepting legal work and a board of directors position from an entity in which he is a current investor, but for which he has not performed legal services in the past?

Introduction:

Undertaking legal work for, and becoming a director of, an entity in which a lawyer is a current investor poses numerous risks and potential conflicts that the lawyer must consider in advance, including, without limitation, the lawyer's ability to perform legal services with competence, instances in which the lawyer will be unable to act effectively as either counsel and/or a director due to conflicts of interest, and possible ramifications on the lawyer's duty of confidentiality and the attorney-client privilege. In many circumstances, the lawyer will need to provide written disclosures to the entity and/or obtain the entity's informed written consent before undertaking representation of the entity. As a director, the lawyer also may need to make certain disclosures of personal interests, where such interests are relevant to matters under consideration by the board of directors.

Factual Hypothetical:

Lawyer is a solo practitioner who provides legal services for clients needing assistance with trust and estate matters. Separate and apart from his legal practice, Lawyer has been a minor investor in Entity X for three years, beginning shortly after its formation. He has not previously performed any legal work for Entity X or its officers, directors or other constituents. Due to the limited number of initial investors, which included certain officers of the company, close relationships developed between Lawyer, on the one hand, and certain of the officers and co-investors, on the other hand. During this time, Entity X's business has experienced significant growth, and the president of Entity X has now asked Lawyer to begin assisting Entity X with its legal needs and also to serve as a member of its board of directors. According to the president's proposal, Lawyer would be paid pursuant to a standard fee arrangement, which would not include the issuance of any additional stock or other forms of security interests in Entity X.

Discussion:

Lawyers have long been asked to serve as directors of organizations due to the knowledge and experience they possess and are able to contribute to board decisions. As a result, it would come as no surprise as the number of start-up companies grows to see an increase in requests for lawyers who are investors in companies to take on legal work for those companies, in addition to director roles.

Although lawyers and directors both owe fiduciary duties to the companies for which they serve, the duties do not overlap precisely,[1] and such dual roles pose a significant number of risks to the lawyer, as well as the company.[2] The potential for conflicts increases even further when the lawyer has a personal financial interest in the organization. (*See, e.g., Lawyers Doing Business with Their Clients: Identifying and Avoiding Legal and Ethical Dangers*, 2001 ABA SEC. OF LITIG., at 43-49, http://www.abanet.org/litigation/ethics/abareport.pdf.) For these reasons, it is essential for a lawyer to thoroughly consider the duties imposed by such a tripartite relationship and the lawyer's ability to competently perform the services expected and provide independent professional judgment to the organization. Due to the risks and potential complications involved in such a scenario, the lawyer should disclose these issues to the appropriate individuals at the organization before accepting such roles and may even be required to obtain the organization's informed written consent, depending on the circumstances. For example, Rule 3-300 of the California Rules of Professional Conduct requires the written consent of the client for attorney-client business transactions where counsel knowingly acquires a pecuniary interest adverse to the client.

Under the fact pattern presented, Lawyer must consider his duty of competence, his professional responsibilities in avoiding or properly dealing with conflicts of interest, and his duty of confidentiality and role in preserving the attorney-client privilege.

I. The Duty of Competence

Rule 3-110 of the California Rules of Professional Conduct[3] provides:

> (A) A member shall not intentionally, recklessly, or repeatedly fail to perform legal services with competence.

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[1] By way of example, a company's lawyer owes a duty of loyalty only to the company, unless he or she is also representing constituents of the company, whereas a company's director owes a duty of loyalty to the company's shareholders, as well as to the company. (*See* Bethany Smith, *Sitting on v. sitting in on your client's board of directors*, Geo. J. Legal Ethics (Spring 2002).) A dual corporate legal advisor/director relationship may even result in the imposition of a heightened standard of care due to expectations of greater knowledge. (*See, e.g., Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 690 (S.D.N.Y. 1968).)

[2] This Opinion focuses on certain specific legal professional responsibility issues that must be considered under the fact pattern presented and should not be construed as an exhaustive discussion of the considerations pertinent to all situations. In addition to other applicable professional responsibility issues, each situation may require an individual review and analysis of, among other things, liability risks, substantive legal issues, securities laws, business concerns, insurance coverage and governance considerations, including director independence.

[3] Unless otherwise noted, all rule references herein are to the California Rules of Professional Conduct.

> (B) For purposes of this rule, "competence" in any legal service shall mean to apply the 1) diligence, 2) learning and skill, and 3) mental, emotional, and physical ability reasonably necessary for the performance of such service.
> (C) If a member does not have sufficient learning and skill when the legal service is undertaken, the member may nonetheless perform such services competently by 1) associating with or, where appropriate, professionally consulting another lawyer reasonably believed to be competent, or 2) by acquiring sufficient learning and skill before performance is required.

Lawyer's practice focuses on trust and estate matters, but if he were to undertake a role in assisting Entity X with its legal matters, it likely would require "learning and skill" in corporate, litigation, and employment law, among other areas. Lawyer will have to determine if he has the time and ability to acquire sufficient knowledge in such areas before he is called upon to provide the assistance. In addition, he will need to discuss the willingness and ability of Entity X to retain other attorneys in the requisite areas as the need arises to assist Lawyer in competently providing the legal services or where conflicts of interest prevent Lawyer from undertaking the representation himself.

If Lawyer is unable to devote the time to acquire the necessary knowledge and skills needed, and Entity X is unwilling or unable, for whatever reason, to fund the retention of additional attorneys as necessary, Lawyer must not accept such legal assignments from Entity X.

II. Adverse Interests and Effects of Dual Roles

If Lawyer determines that he can competently perform legal services for Entity X, he will have to be alert to potential and actual adverse interests that may arise. A lawyer must avoid conflicts of interest with his or her clients, or, if permissible under the circumstances, he or she may undertake or continue with a representation notwithstanding such a conflict if the attorney provides the necessary written disclosures to the client and obtains any required informed written consent to the representation from the client or clients, despite the conflict. (Rule 3-310.)

Ordinarily, a business relationship between an attorney and a client would create such an adverse interest, implicating the requirements of Rule 3-300, which states:

> A member shall not enter into a business transaction with a client; or knowingly acquire an ownership, possessory, security, or other pecuniary interest adverse to a client, unless each of the following requirements has been satisfied:
> (A) The transaction or acquisition and its terms are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which should reasonably have been understood by the client; and
> (B) The client is advised in writing that the client may seek the advice of an independent lawyer of the client's choice and is given a reasonable opportunity to seek that advice; and
> (C) The client thereafter consents in writing to the terms of the transaction or the terms of the acquisition.

Rule 3-300's statutory complement, Section 16004 of the California Probate Code,[4] provides that where such a business transaction *occurs during the existence of the relationship*, it is presumed to violate the lawyer's fiduciary duty. (Cal. Prob. Code § 16004(c); *see BGJ Assocs., LLC v. Wilson*, 113 Cal. App. 4th 1217, 1227-28 (2003) (applying Section 16004(c) of the Probate Code to the fiduciary relationship between attorney and client).) In the fact pattern presented, however, Lawyer has a pre-existing business relationship with Entity X, having been an investor since shortly after the company's inception. Because the attorney-client relationship in this situation arises *after* the investment or business transaction, it is the OCBA's opinion that the requirements of Rule 3-300 would not apply. Further, pursuant to the proposal of the president of Entity X, when undertaking legal work for the company, Lawyer would be paid under a standard fee arrangement, not involving the issuance of additional stock or other forms of equity or debt arrangements with the company. In this regard, the Discussion to Rule 3-300 states that the Rule "is not intended to apply to the agreement by which the member is retained by the client, unless the agreement confers on the member an ownership, possessory, security, or other pecuniary interest adverse to the client." (Discussion to Rule 3-300.)

If the circumstances were to change and Lawyer were to receive additional forms of equity or debt interests in Entity X in exchange for his performance of legal services, or, if after the client relationship develops, Lawyer's equity interests in the company would be altered, he enters into any sort of business transaction with Entity X, or he "knowingly acquire[s] . . . [a] possessory, security or other pecuniary interest adverse to [the] client[,]" then Lawyer would have to comply with subdivisions (A) through (C) of the Rule. (*See, e.g., Mayhew v. Benninghoff*, 53 Cal. App. 4th 1365, 1367 (1997) (to meet the high presumptions designed to protect clients in their business dealings with attorneys, "[t]he onus is on the attorney to show no advantage was taken and that the client was given full and frank disclosure").) This may include certain transactions that could arise in connection with service on the board of directors if Lawyer were to take a position on the board after beginning to assist with Entity X's legal needs.[5] However, Rule 3-300 is not intended to apply, according to the Discussion to the Rule, "where the [attorney] and client each make an investment on terms offered to the general public or a significant portion thereof." (Discussion to Rule 3-300.) The example given for this is:

> [W]here A, a member, invests in a limited partnership syndicated by a third party. B, A's client, makes the same investment. Although A and B are each investing in

[4] Section 16004(c) states: "A transaction between the trustee and a beneficiary which occurs during the existence of the trust or while the trustee's influence with the beneficiary remains and by which the trustee obtains an advantage from the beneficiary is presumed to be a violation of the trustee's fiduciary duties. This presumption is a presumption affecting the burden of proof. This subdivision does not apply to the provisions of an agreement between a trustee and a beneficiary relating to the hiring or compensation of the trustee."

[5] Once an attorney-client relationship has been established, contractual relationships between a client and its lawyer will be subject to scrutiny for fairness and general principles of fiduciary duty may apply. (*See, e.g., Ritter v. State Bar*, 40 Cal.3d 595, 602 (1985) *(*"The 'relationship between an attorney and client is a fiduciary relationship of the very highest character. All dealings between an attorney and his client that are beneficial to the attorney will be closely scrutinized with the utmost strictness for any unfairness.' (*Clancy v. State Bar* (1969) 71 Cal.2d 140, 146 [77 Cal.Rptr. 657, 454 P.2d 329]; *Marlowe v. State Bar* (1965) 63 Cal.2d 304, 308 [46 Cal.Rptr. 326, 405 P.2d 150]; *Magee v. State Bar* (1962) 58 Cal.2d 423, 430 [24 Cal.Rptr. 839, 374 P.2d 807].)".)

> the same business, A did not enter into the transaction "with" B for the purposes of the rule.

Moreover, Lawyer must provide the requisite disclosures to Entity X under subdivision (B)(4) of Rule 3-310 ("The member has or had a legal, business, financial, or professional interest in the subject matter of the representation."). In addition, other provisions of this Rule may apply and require written disclosures and/or informed consent depending on the legal work being requested, such as, by way of example only, if Lawyer were asked to perform legal services for Entity X that would be adverse to one of Lawyer's former or current clients (subdivisions (B)(2), (B)(3) & (E)).[6] Other disclosures also may be necessary if Lawyer's interest in Entity X becomes adverse to the company in any manner, such as where a dispute develops regarding the terms of Lawyer's investment. In this regard, conflicts could arise between Lawyer's legal advice or board decisions and his interests as an investor, which could impact his independent professional judgment. (*See, e.g.*, ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 00-418 (2000) ("At the outset, the lawyer also should inform the client that events following the stock acquisition could create a conflict between the lawyer's exercise of her independent professional judgment as a lawyer on behalf of the corporation and her desire to protect the value of her stock.").) Again, disclosures may be necessary and, in some cases, Lawyer may not be able to participate in such decisions or legal issues.[7]

Further, Lawyer will have to be alert to conflicts and potential problems that could result from serving both as Entity X's attorney and as a board member, such as abiding by his duty of confidentiality and preserving the confidentiality of privileged communications (*e.g.*, where it is

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[6] If a lawyer were to maintain his or her employment by, or partnership interest in, a law firm while serving as the legal advisor to and/or a director of an organization, he or she must be diligent about checking for potential conflicts in representations before undertaking any legal assignments or participating in board decisions that may impact another client. If the lawyer and law firm do not properly address potential and actual conflicts, the duty of loyalty to each client is at issue. The duty of confidentiality may be impacted as well. The potential consequences to the lawyer and law firm include sanctions for violations of the Rules of Professional Conduct, disqualification, and lawsuits for breach of fiduciary duty and/or malpractice.

[7] Note that Comment 35 to Rule 1.7 of the ABA Model Rules of Professional Conduct states that, if there is a material risk of interference with the lawyer's independence of professional judgment, the lawyer should not serve as a director or cease to act as company counsel when conflicts of interest arise:

> A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is 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. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

unclear whether Lawyer is acting as a director or a lawyer)[8] and dealing with possible conflicts where legal advice is requested on matters in which he was involved as a director. (*See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998) (ethical concerns exist where lawyer-director serves as counsel in a matter that he or she opposed as director, opines on past board actions in which he or she participated, or acts as director in corporate actions affecting him or her as a lawyer).) Disclosures likely will be necessary, and Entity X should be apprised that it may impact Lawyer's ability to participate in certain board actions or advise on/undertake certain legal matters. (*See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998) (describing certain problems that may arise from dual role as corporate counsel and director, and providing general advice).)

In advising Entity X of these possible consequences in accordance with Rule 3-310,[9] Lawyer should inform the company, among other things, that, if Lawyer were not able to participate in a legal matter and other counsel would have to be retained, Entity X may be subject to additional time and expense in getting other counsel involved. Similarly, Lawyer should inform Entity X that, if he is unable to participate in a particular board decision or matter, Entity X will lose the experience and advice of one of its board members and have a fewer number of directors available to consider and vote on the issue.

Lawyer also will need to comply with Rule 3-600. Because Lawyer would be representing Entity X, and not his fellow board members, or the company's officers, employees and other investors, he will need to explain this to Entity X's constituents, particularly if it "becomes apparent that the [company's] interests are or may become adverse to those of the constituent(s) with whom the member is dealing." (Rule 3-600(D).) The Rule further provides that "[t]he member shall not mislead such a constituent into believing that the constituent may communicate confidential information to the member in a way that will not be used in the organization's interest if that is or becomes adverse to the constituent." This is particularly important here where Lawyer has developed close relationships with certain of Entity X's constituents who may not see the distinction or may believe that Lawyer will protect them because of their relationship.

Finally, as a director, Lawyer may need to make certain disclosures of personal interests, where such interests are relevant to matters under consideration by the board of directors, such as Lawyer's financial interest in another company with which Entity X is considering entering into a relationship. These director disclosures, which are fiduciary in nature, may or may not overlap with the Lawyer's role and duties as legal advisor to Entity X, but nonetheless may result in conduct that could subject Lawyer to attorney discipline if not handled properly. For example, Section 6106 of the California Business and Professions Code provides:

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[8] The attorney-client privilege may be challenged where communications arguably involve business issues, as opposed to legal advice. (*See, e.g., SEC v. Gulf & Western Indus., Inc.*, 518 F. Supp. 675, 681-83 (D.D.C. 1981).) As a consequence, lawyers should clearly advise management and their fellow directors when they are giving advice as a lawyer, as opposed to as a director, appropriately mark legal advice as confidential and attorney-client privileged, and take precautions against disclosures to unnecessary individuals when providing legal advice to avoid waiver of the privilege.

[9] Subdivision A of Rule 3-310 defines "disclosure" as "informing the client or former client of the relevant circumstances and of the actual and reasonably foreseeable adverse consequences to the client or former client."

> The commission of any act involving moral turpitude, dishonesty or corruption, whether the act is committed in the course of his relations as an attorney or otherwise, and whether the act is a felony or misdemeanor or not, constitutes a cause for disbarment or suspension. If the act constitutes a felony or misdemeanor, conviction thereof in a criminal proceeding is not a condition precedent to disbarment or suspension from practice therefor.

As the Review Department of the State Bar Court has stated, "an attorney's deliberate breach of a fiduciary duty or a breach resulting from the attorney's gross carelessness and negligence involves moral turpitude even in the absence of an attorney-client relationship. That is because '[a]n attorney who accepts the responsibility of a fiduciary nature is held to the high standards of the legal professional whether or not he acts in his capacity of an attorney.'"[10] (*In the Matter of Kittrell*, 4 Cal. St. Bar Ct. Rptr. 195, No. 95-O-14321, 2000 WL 1682426, at *10 (Cal. Bar Ct. Oct. 26, 2000), quoting *Worth v. State Bar*, 17 Cal.3d 337, 341 (1976).)

Conclusions:

Accepting the roles of legal advisor and director for a company in which a lawyer has invested raises a number of professional responsibility issues that should be considered in advance, such as the lawyer's ability to perform legal services with competence, the ability to act effectively as either counsel and/or a director due to conflicts of interest, and possible ramifications on the lawyer's duty of confidentiality and the attorney-client privilege. Each circumstance will require an individual assessment under the Rules of Professional Conduct, State Bar Act and other applicable law, but will often require written disclosures to the organization and/or the organization's informed written consent before undertaking the representation. In addition, as a director, the lawyer also may need to make certain disclosures of personal interests, where such interests are relevant to matters under consideration by the board of directors.

[10] *See* ABA Model Rules of Prof'l Conduct 8.4 ("It is professional misconduct for a lawyer to: …(c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation…."); cmt. [2] ("…Although a lawyer is personally answerable to the entire criminal law, a lawyer should be professionally answerable only for offenses that indicate lack of those characteristics relevant to law practice. Offenses involving violence, dishonesty, breach of trust, or serious interference with the administration of justice are in that category…."); cmt. [5] ("Lawyers holding public office assume legal responsibilities going beyond those of other citizens. A lawyer's abuse of public office can suggest an inability to fulfill the professional role of lawyers. The same is true of abuse of positions of private trust such as trustee, executor, administrator, guardian, agent and officer, director or manager of a corporation or other organization.").

the Committee. In utilizing these Opinions, one should be aware that subsequent judicial opinions and revised rules of professional conduct may have addressed the areas covered by these Opinions.