

## **SDCBA Legal Ethics Opinion 2017-1**

(Adopted by the San Diego County Bar Legal Ethics Committee October 17, 2017)

**ISSUE:** What ethical obligations arise when lawyers in a firm represent clients in litigation that arises out of legal services another lawyer in the firm performed for the clients; do those ethical obligations change when that other lawyer discovers documents material to the litigation that may give rise to the clients having a claim against the lawyer and the firm?

**DIGEST:** Clients often have lawyers in a firm with which they have a relationship represent them in litigation even if the litigation arises out of legal services the firm performed. Such representation, however, raises ethical issues. Does the firm have a conflict of interest, potential or actual? What must the firm do if it is to represent the company and its officers and directors? May the law firm undertake the representation at all? What else, if anything, must the firm do as the facts evolve? At the outset, the firm must obtain the informed written consent of each jointly represented client and fully disclose to each client in writing the firm's potential professional and financial interest in the litigation's outcome because of legal services it provided. Once the lawyer discovers the documents, the firm must fully disclose that fact and its ramification to each client, including the new, inherent conflicts of interest between the firm and its clients.

### **AUTHORITIES**

**INTERPRETED:** Rules 3-310, 3-600, 3-500, 5-200, 5-210 of the Rules of Professional Conduct of the State Bar of California;<sup>1</sup> Business and Professions Code section 6068, subdivisions (m) and (d)

### **STATEMENT OF FACTS**

Bob is a general transaction lawyer who prepared all the documents necessary for a small company's initial public offering. Charlie, a long-standing client and friend, was the company's majority owner. Bob filed the documents with the Securities Exchange Commission. After the requisite SEC comment and waiting period, the IPO proceeded and the company sold stock to the public. As part of the IPO, company officers and directors, including Charlie, sold personal shares to the public.

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<sup>1</sup> Unless otherwise stated, all references to rules are to the Rules of Professional Conduct of the State Bar of California.

<sup>2</sup> *Flatt v. Superior Court* (1995) 9 Cal.4th 275, 289 ("The [conflict of interest] rule is

Six months later, a public shareholder filed a class action lawsuit against the company and its officers and directors, alleging that the IPO disclosure and public offering documents were materially deficient. The complaint charged that the offering documents failed to disclose information about specific related-party transactions—specifically involving Charlie and another officer/director—that securities law required be disclosed. This information, the complaint alleged, was material and necessary for the public documents not to be false and misleading.

Bob insisted to Charlie, CEO and still a significant shareholder, that trial lawyers in Bob's firm were best equipped to represent both the company and the individual defendants in the class action. He argued that his firm knew all the facts and had known all the people involved—some, for years. The company and the officers and directors acquiesced in Bob's recommendation.

Shortly after the representation began, Bob reviewed his files from the IPO. He found his notes, since forgotten, from a meeting with company officers and directors; the notes outlined some related-party transactions identified in the class action lawsuit.

## **DISCUSSION**

### **Conflicts Of Interest**

The California Rules of Professional Conduct prohibit lawyers from representing clients whose interests potentially or actually conflict, without the informed written consent of each client. (Rule 3-310.) Here, the law firm has several conflicts of interest which it must address before it can undertake representation of both the company and its officers and directors as defendants in the securities litigation.

#### **The First Conflict—Requirements For Joint Representation—at the Outset**

Rule 3-600 provides that when a lawyer represents an organization—here the corporation—the lawyer must recognize that the organization itself is the client, acting through its highest authorized officer or constituent overseeing the representation.

Bob and his firm first represented the company, not any officer or director, in performing the legal work for the company's IPO. As a consequence, Bob and his firm first owe a duty of uncompromised loyalty to the corporation; Charlie, as an officer and director, was only the constituent member of the organization overseeing the engagement. And that continues to be the case. (Rule 3-600(A))

Representation of an organization, however, does not preclude a lawyer from also representing one of its shareholders, officers or directors, or another employee (Rule 3-600(E)), subject to the provisions of Rule 3-310 that address conflicting interests. If, however, there is a potential or actual conflict of interest between the entity and the officer, director or employee to be jointly represented, triggering Rule 3-310's requirements—primarily informed written consent of both clients (Rule 3-310(C))—an

appropriate constituent of the organization other than the individual whom the lawyer will also represent must give the organization's informed written consent to the joint or multi-party representation.

Here, the lawsuit charges both the company and its officers and directors with the failure to disclose material related-party transactions, and specifically identifies transactions between Charlie and another director and the company itself. So, there is at least a potential conflict of interest between (or among) Charlie and the other director and the company. Arguably, there could also be a conflict for any other officers or directors to the extent that they knew or should have known about the related-party transactions at the time of the IPO.

Accordingly, before the firm may begin representing the company and any officer or director in the litigation, it must first comply with the requirements of Rule 3-310(C)(1) or Rule 3-310 (C)(2) for potential or actual conflicts of interest, respectively. In addition, the firm must determine who, in the circumstances of this shareholder lawsuit, could authorize a joint representation within the dictates of Rule 3-600(E).

### **Rule 3-310 Requirements**

A lawyer may not without each client's "informed written consent":

Accept representation of more than one client in a matter in which the interests of the clients potentially conflict (Rule 3-310(C)(1)); or

Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict (Rule 3-310(C)(2)).

"Informed written consent" requires each client to agree in writing to the representation following written disclosure. (Rule 3-310(A)(2).) "Written disclosure" requires that the lawyer inform the client of the "relevant circumstances" and the "actual and reasonably foreseeable adverse consequences" of the conflict. (Rule 3-310(A)(1).) While the Rules do not expressly define "relevant circumstances," at a minimum the lawyer must explain to the client the facts and basis for the actual or potential conflicts of interest. (Rule 3-310, Discussion.) "Reasonably foreseeable consequences" means that the lawyer must also tell the client about the problems associated with the joint representation and explain, in terms the client can understand, how the problems might affect the client or the client's relationship with the lawyer.

Accordingly, each client involved in the conflict must agree in writing to the representation following the lawyer's full written disclosure of the "relevant circumstances" and the "actual and reasonably foreseeable adverse consequences to the client or former client."

Thus, "informed written consent" requires affirmative evidence that the client (1) discussed the potential drawbacks of the representation with the lawyer or independent counsel; (2) had been made aware of the dangers and possible consequences of the

representation; (3) knew his or her right to conflict-free representation; and (4) voluntarily chose to waive that right.

### **The Disclosures**

Under the facts we have, the disclosures must include, at a minimum: (1) that the individual clients may have claims against one another; (2) that the company may have claims against individual officers or directors; and (3) that the provisions of Evidence Code section 962 waive the attorney-client privilege for any communications during the joint representation in any subsequent litigation between or among them arising out of this representation.

### **Independent Counsel**

Rule 3-310, unlike Rule 3-300 (Interests Adverse to a Client), does not require a lawyer obtaining two or more clients' informed written consent for a joint representation to advise them to seek the advice of an independent lawyer before giving that consent. Rule 3-310 requires informed written consent after full disclosure of reasonably foreseeable adverse consequences of the joint representation (*i.e.*, that the consent is "informed"). We address below whether the circumstances of these hypothetical facts mandate advising the company and each officer and director to seek such independent advice before entering into the multi-party representation.

### **The Consents**

No officer or director can give informed written consent to his or her own joint representation (Rule 3-600(E)). Thus, someone with authority in the company other than the conflicted constituent must sign off on behalf of the organization.

### **The Second Conflict—The Law Firm Itself**

When a lawyer has a financial or professional interest in the subject matter of the representation, Rule 3-310(B)(4) requires the lawyer to give the client written disclosure of that fact.

Here, Bob and his firm prepared all the documents for the IPO and the related SEC filings. It is in the law firm's interest, as well as that of the company and its officers and directors, that the outcome of the litigation results in a finding that there was no failure to disclose material information in those documents. Thus, the principal focus of the defense may be to demonstrate that all material information was timely disclosed and the alleged non-disclosures either did not exist or that any information not disclosed was immaterial for purposes of the securities laws.

It is, however, in the law firm's interest that, *if* there is a finding that the IPO documents did *not* disclose material information, the law firm did not know, and could not have known, that information at the time of the IPO or the SEC filings. In this setting, the focus of the defense may be the same as above, but it may also attempt to shield Bob and

the firm: namely, that he and it did not know, and could not have known, about any alleged related-party transactions.<sup>2</sup>

Thus, Bob and his firm have vested financial and professional interests in the outcome of the subject matter of this representation and must make full disclosure of the potential conflict to the company and each officer and director. Rule 3-310(B), however, does not require the clients' written consent for the representation to proceed.

### **The Third Conflict—Bob**

After the representation of company and officers and directors has begun, Bob found notes of a meeting with directors and officers at which they discussed related-party transactions. This event not only triggers additional duties on his and the firm's part, but also raises further conflict of interest issues.

### **Duty To Inform the Clients**

Rule 3-500 and Business and Professions Code section 6068, subdivision (m), mandate that a lawyer keep a client reasonably informed about significant developments relating to the lawyer's engagement or the representation. Unquestionably, Bob's finding his notes is a significant development that he must communicate to all clients. But the notes raise other issues.

The duty of communication requires a lawyer to disclose the facts that give rise to any legal malpractice claim against the lawyer.<sup>3</sup> A lawyer, however, is not required specifically to disclose that the client may have a malpractice claim against the lawyer; to do so would be to provide legal advice to the client on an issue on which the lawyer's interests squarely conflict with the client's.<sup>4</sup>

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<sup>2</sup> *Flatt v. Superior Court* (1995) 9 Cal.4th 275, 289 (“The [conflict of interest] rule is designed not alone to prevent the dishonest practitioner from fraudulent conduct, but as well to preclude the honest practitioner from putting himself in a position where he may be required to choose between conflicting duties, or be led to attempt to reconcile conflicting interests, rather than to enforce to their full extent the rights of the interest which he should alone represent.”)

<sup>3</sup> State Bar of California Formal Opinion 2009-178 at 4 (citing *Beal Bank, SSB v. Arter & Hadden, LLP* (2007) 42 Cal.4th 503, 514 (“attorneys have a fiduciary obligation to disclose material facts to their clients, an obligation that includes disclosure of acts of malpractice.”)); see also *Palmer v. Superior Court* (2014) 231 Cal.App.4<sup>th</sup> 1214, 1234 (duty to report acts of malpractice to clients).

<sup>4</sup> See Colorado Formal Ethics Opn. No. 113 (November 19, 2005) (“[t]he lawyer need not advise the client about whether a claim for malpractice exists, and indeed the lawyer's conflicting interest in avoiding liability makes it improper for the lawyer to do so.”); see also North Carolina 2015 Formal Ethics Opn. No. 4, p. 3.

Bob did not remember his notes when he and the firm made the required initial disclosures under Rule 3-310(B)(4) discussed above about the firm's vested financial and professional interest in the subject matter of the representation. Because of the importance of this discovery of Bob's notes to the litigation itself, and the possibility that the notes may be discoverable, Bob and the firm must disclose their existence and content to the company and the officers and directors whom they represent, and may not continue with the representation until they do. (Rule 3-310(B)(4).)

**Rule 5-200 and Business and Professions Code Section 6068, subdivision (d).**

Both the Rule of Professional Conduct and the State Bar Act provision require a lawyer to use only those means that are consistent with the truth and prohibit misleading any judicial officer by "any artifice or false statement of fact or law." At a minimum, Bob's after-the-fact discovery of notes outlining some of the undisclosed related-party transactions that form the basis of the lawsuit may preclude the firm's lawyers from taking the position in court in the litigation that the company did not know, and could not have known, about these transactions before the public offering—without regard to their materiality under the securities laws. While the notes themselves *may* be subject to attorney-client privilege protection from discovery, as facts Bob learned while representing the company during that meeting of the directors, the privilege would, at best, protect only the notes and Bob's knowledge—not what each director independently knew. The notes are some evidence of that knowledge. Can the firm's lawyers argue—or put on evidence—that the company and its directors had *no* knowledge of the related-party transactions?

**Bob As Witness.**

Rule 5-210 prohibits a lawyer from acting as an advocate before a jury when that lawyer will also testify about a contested issue of substance without the client's informed written consent. Even if we assume that this lawsuit will end in a jury trial, Rule 5-210 does not technically apply; Bob will not be the one trying the case. But that does not end the Firm's ethical obligations to these clients.

The firm must assume that Bob's notes may be discoverable, or that he may be compelled to testify truthfully whether he knew about the related-party transactions before the IPO took place; and, even, how he knew. If the case goes to trial with the firm representing the company and the officers and directors, Bob's litigation partners will be in the position of arguing *his* credibility about the materiality of these transactions and *his* reasons for not including them in the IPO and SEC documents. This raises at least the risk that the trial lawyers may be tempted to focus on trying to shield Bob and the firm—instead of focusing solely on the argument that the company and its officers and directors disclosed all material facts to their lawyer and relied "in good faith on the specific course

of conduct recommended by the attorney” properly to prepare the IPO and SEC documents.<sup>5</sup>

### **The Firm’s Possible Malpractice**

With the claims in the lawsuit about material nondisclosure, and with the fact of Bob’s notes, the firm must face the possibility at least of a subsequent malpractice action against Bob and the firm. These facts trigger at least two issues: what must the firm tell the clients; must the firm refer the clients to independent counsel before continuing the representation?

#### **Duty To Inform The Client**

As discussed above, Rule 3-500 and Bus. & Prof. Code section 6068(m) mandate keeping a client reasonably informed about significant developments. The rule parallels a lawyer’s common law fiduciary duty, which includes an obligation to “disclose all material facts,” including “acts of malpractice.” The disclosure must be prompt and intentional failure to disclose a material fact, in violation of fiduciary duty, is a form of actionable fraud. While not every “mistake” mandates disclosure to the client, when a lawyer is aware of a significant mistake, the rule and the State Bar Act provision require disclosure.

When disclosure is required, then the lawyer must balance the duty to disclose material facts against the reality that the lawyer has a conflict of interest that bars the lawyer from advising the client concerning the legal significance of that error. Thus, not only should any mistake and its potential consequences be described as neutrally as possible, but it also raises the potential conflict of interest and the issue of referral to independent counsel.<sup>6</sup>

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<sup>5</sup> *United States v. Bush*, 626 F.3d 527, 539 (9th Cir. 2010) (invoking “advice-of-counsel” defense in securities fraud case); see also *S.E.C. v. Goldfield Deep Mines Co of Nevada*, 758 F.2d 4549, 467 (9th Cir. 1985); *S.E.C. v. Strategic Global Instruments, Inc.*, F.Supp.3d, 2017 WL 1387187, p. \*11 (S.D. Cal. April 17, 2017) (advice-of-counsel defense precludes asserting the attorney-client privilege for those communications, citing *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992). This opinion does not address whether, as a matter of risk mitigation for the firm, Rule 3-310(B)(4) disclosures are sufficient—because of Bob’s notes, the possibility of his having to testify and potential loss of an “advice-of-counsel” defense—or whether the firm should advise the clients to obtain the advice of independent counsel before allowing the firm to continue the representation.

<sup>6</sup> See discussion at p. 5, above.

## **Obligation to Refer The Clients to Independent Counsel**

*Currently*, no California Rule of Professional Conduct, nor any provision of the State Bar Act *expressly* requires a lawyer to advise a client to seek independent counsel regarding an error the lawyer has made.

State Bar Formal Opinion 2009-178 addresses whether a lawyer may settle a fee dispute where the settlement includes the release of a potential malpractice claim. While not directly in point to our facts, the opinion addresses the obligation in the facts presented in that opinion to advise the client to get the advice of independent counsel. Colorado Bar Association Formal Opinion 113 reaches the same conclusion.

As Formal Opn. 2009-178 instructs, Rule 3-500 mandates that lawyers keep a client reasonably informed about significant developments related to the representation. The fiduciary duty to communicate requires the full and fair disclosure to the client of any procedural or substantive matters that would materially affect his client's rights and interests.<sup>7</sup>

But a lawyer need not advise the client about whether those facts support a valid claim for malpractice. Indeed, doing so may put the lawyer in a conflict position under Rule 3-310(B) due to the lawyer's professional relationship with the client and personal and professional interests in the subject. So, the lawyer need not, and should not, make an admission of liability. What must be disclosed, however, are the facts that surround the error. At that time, the lawyer should inform the client that it may be advisable to consult with an independent lawyer with respect to the potential impact of the error on the client's rights or claims and on any potential malpractice claim.

When Rule 3-310(B) is implicated, lawyers have a duty to disclose the conflict to their clients. Under the rule, disclosure means informing the clients of the relevant circumstances (i.e., the error made) and the actual and reasonably foreseeable consequences to the clients. In such situations, lawyers would be expected to disclose, among other things, how a decision whether to continue or terminate the representation may impact the clients' rights against the attorney and the matter itself. Because of the inherent conflict, however, in such a disclosure—which would require a fair assessment of potential claims against the lawyer or law firm itself—and, because of the inability of the lawyer or law firm to give the clients objective advice, although no Rule of Professional Conduct expressly mandates that the firm instruct the clients to obtain an independent legal opinion, we conclude that the circumstances of this hypothetical require the firm to give its clients such an instruction.

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<sup>7</sup> *Neel v. Magana, Olney, Levy, Cathcart & Gelfand* (1971) 6 Cal.3d 176.) (California courts have consistently held that the duty to communicate extends to and includes information about errors that the lawyer makes during the representation. See, e.g., *Palmer v. Super. Ct.* (2014) 231 Cal.App.4th 1214.)

California’s proposed Rule of Professional Conduct 1.7 (Conflict of Interest: Current Clients)—presently before the California Supreme Court—would support our conclusion.<sup>8</sup> The proposed rule recognizes that a conflict of interest can exist if a “lawyer’s own interests” would “materially limit” the lawyer’s representation of the client. Similarly, ABA Model Rule 1.7, with its same “material limitation” language reinforces this conclusion.

Once the law firm fulfills its obligation to disclose the facts to the clients—including the facts about Bob’s notes—the clients must decide whether it is in their best interests in the circumstances to continue to employ the law firm in the litigation.<sup>9</sup>

### **Obligation To Withdraw**

At the beginning of the representation, if the firm obtained the appropriate conflict of interest waivers from the company and the individual officers and directors, in spite of the potential conflicts, the firm was permitted to undertake the joint representation of all defendants. Once Bob discovers his notes, however, the circumstances of the representation changed dramatically. Nothing in the text of Rule 3-310 or authority interpreting it addresses directly the circumstances in which Bob and his firm find themselves after he discovers the notes of the meeting. The ABA model Rules, however, and in particular its conflict of interest rule provide helpful guidance.

### **The ABA Model Rules**

Although the ABA Model Rules are not binding in California, they provide California lawyers with authoritative guidance where there is no direct California authority and where the ABA Model rules do not conflict with California policy. As a consequence, in the absence of California authority, or to supplement that authority, California lawyers should look to the ABA Model rules, and the ABA Formal Opinions interpreting them, as well as the ethics opinions of other jurisdiction or bar associations for guidance. “Thus, especially where there is no conflict with the public policy of California, the ABA Model Rules serve as a collateral source for guidance on proper professional guidance in

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<sup>8</sup> The California Commission of the Revision of the Rules of Professional Conduct submitted to the Court, in March 2017, proposed revised Rules of Professional Conduct, after an iterative process involving significant comment from a broad spectrum of professional responsibility experts and other interested persons throughout California. The Court may adopt, reject or suggest modifications of the proposed rules, but currently they appear to embody a consensus of the collective professional responsibility expertise in California on what the ethical obligations of its lawyers should be.

<sup>9</sup> This opinion recognizes that, as laymen, the clients may suffer a handicap making that decision without the advice of counsel; but the firm has an inherent conflict of interest and cannot give that advice. Accordingly, as a matter of best practices, the law firm may consider advising the clients to seek the advice of independent counsel, but it currently has no ethical obligation to do so.

California.”<sup>10</sup> California courts in fact apply the ABA Model Rules in addressing questions of professional responsibility. “[A]lthough California has not adopted the ABA Model Rules, they may be ‘helpful and persuasive in situations where the coverage of our Rules is unclear or inadequate.’ [Citations.]”<sup>11</sup>

### **Model Rule 1.7 (Conflict of Interest: Current Clients)**

ABA Model Rule may give guidance for Bob and his firm in the circumstances of this case. The rule provides that a current conflict exists if there is a significant risk that the representation of one or more clients will be *materially limited* by, among other things, “a personal interest of the lawyer.” Moreover, the affected clients cannot waive such a “material limitation” conflict unless, the conflict notwithstanding, the lawyer believes that he or she will be able to provide competent and diligent representation to each affected client. As the comment to this provision of the rule points out: “For example, if the probity of a lawyer’s own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice.” (Comment [10].)

Here, Bob’s own conduct—what he knew and when—as well as that of others in the firm who may have worked on the IPO will be at issue. Similarly, the firm’s litigation partners, having already undertaken the representation—once confronted with the revelations about Bob’s notes—are necessarily aware of the potential jeopardy to the firm. As a consequence, we believe ABA Model Rule 1.7 provides important guidance in the circumstances of this hypothetical.

In these circumstances, independent counsel—should the clients consult that counsel—may conclude that the firm cannot continue the representation of either the company or the individual officers and directors in the litigation—because of the firm’s lawyers’ duty of candor to the court, because of the risk of losing an “advice of counsel” defense, and because of the inherent and actual conflict of interest between the financial and professional interests of the firm and the litigation interests of the client.<sup>12</sup>

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<sup>10</sup> *Kennedy v. Eldridge* (2011) 201 Cal.App.4th 1197, 1210, internal quotation marks and citations omitted; see *City & County of San Francisco v. Cobra Sollutions, Inc.* (2006) 38 Cal.4th 839, 852 (While California has not adopted the ABA Model rules, they may nevertheless be used as guidance for lawyers absent on-point California authority or a conflicting state public policy.); State Bar Formal Opinion No 2013-188. See e.g. *People v. Donaldson* (2011) 93 Cal.App.4th 916, 928; *Kennedy, supra* at 1209-1211 (disqualification based on ABA advocate/witness rule in a bench trial even though California rule requires disqualification only in a jury trial).

<sup>11</sup> *Frye v. Tenderloin Housing Clinic, Inc.* (2006) 38 Cal.4th 23, 52, n. 12.

<sup>12</sup> Again, as a matter of risk mitigation and best practices, the firm may wish independently to consider whether it should, consistent with Rule 3-700, withdraw from the representation.

## CONCLUSIONS

We conclude that, at the outset of the litigation, the law firm may, so long as it complies with Rule 3-310 and obtains the informed written consent of the company and each officer/director client, jointly represent all the defendants in the class action litigation.

We further conclude that the firm must, at the outset, fully disclose to each client in writing the firm's potential professional and financial interest in the litigation's outcome.

Once, however, Bob discovers his notes of the meeting at which related-party transactions at issue in the lawsuit were discussed, we conclude that the firm must fully disclose that fact and its ramifications to each client, including the new, inherent conflicts of interest between the firm and its clients.