

Question 1

Betty formed and became president and sole shareholder of a startup company, ABC, Inc. ("ABC"), which sells a daily on-line calendaring service. ABC retained Lucy, a lawyer, to advise it about a new trademark.

As ABC was very short on cash, Lucy orally proposed that, in lieu of receiving her usual \$200 per hour fee, she could become a 1% owner of ABC. On behalf of ABC Betty orally agreed. Lucy performed 20 hours of legal work and received her ABC stock shares. Years later, Lucy would sell her shares back to Betty for \$40,000.

While Lucy was performing legal services for ABC, she discovered certain representations by ABC that were false and misleading and caused customers to pay for services they would never receive. She reported her discovery to Betty, who told her to ignore what she had found. After Lucy finished her legal work for ABC, she reported the false and misleading representations to a state consumer protection agency.

Betty sold all of her interest in ABC, including the shares previously held by Lucy, and formed and became president and sole shareholder of another startup company, XYZ, Inc. ("XYZ").

After Lucy had finished her work for ABC and closed that file, she was retained by a new client, Donna, in a trademark dispute with XYZ.

What ethical violations, if any, has Lucy committed? Discuss.

Answer according to California and ABA authorities.

Answer A to Question 1

Attorneys owe their clients the duties of confidentiality, loyalty, fiduciary responsibility, and competence. They owe the public and the courts the duties of candor and truthfulness, fairness, and the obligation to uphold the dignity and decorum of the legal profession. Here, Lucy's conduct implicates the duties of confidentiality, loyalty, and fiduciary responsibility.

1. Lucy & ABC's Fee Agreement

Lucy and ABC have entered into a fee agreement whereby Lucy will receive a 1% ownership interest in ABC as the fee for her legal services, rather than her usual \$200 per hour fee.

A. Requirement of Written Fee Agreements

Fee agreements between lawyers and clients must generally be in writing unless the fee to be charged will be less than \$1,000, the work is routine work for a regular client, the client is a corporation or business organization, or the circumstances of the engagement make a written agreement impractical or impossible. Here, the agreement between Lucy and ABC does not appear to have been reduced to writing. The facts indicate that Lucy orally proposed the terms and that Betty orally agreed to them. However, ABC is a corporation. Therefore, it falls within the exception requiring the fee agreement to be in writing. Accordingly, Lucy has not breached any ethical duty by entering into what appears to be an oral fee agreement.

B. Accepting Ownership Interest in Client's Business As Fee For Legal Services

When a lawyer holds an ownership interest in a client's business, the duty of loyalty is implicated. The duty of loyalty requires an attorney to put his or her client's interest ahead of his own. When a lawyer holds an interest in a business that is also a client, the lawyer must be able to separate his or her own interest from that [of] the business, and must be able to put the business' interest ahead of his or her own interest. Generally, a lawyer is permitted to accept an interest in a client's business as part or all of the fee for legal services. However, consent must [be] in writing and [must] obtain independent legal counsel before entering into the transaction.

In this case, it is not clear that there was any consent by ABC in writing. Moreover, it does not appear that Lucy advised Betty or ABC to obtain independent legal counsel with regard to the transaction, nor does it appear that Betty or ABC obtained such advice. Accordingly, Lucy has violated the rules of professional conduct.

C. Reasonableness of Fee

Under the ABA Model Rules, a lawyer's fee must be reasonable, taking into account a number of factors, including the amount of work required, the complexity of the matter, the lawyer's skill and experience and other factors. Under the California rules, a fee must not be "unconscionable" (that is, it must not "shock the conscience"). Here, Lucy's "normal" fee was \$200 per hour. The facts do not indicate Lucy's experience or skill level or what type of matters she normally handled, but a \$200 per hour fee would likely be considered to be reasonable. The facts do not indicate any value of ABC at the time of the fee agreement or at the time Lucy performed the services for ABC. However, Lucy sold her shares in ABC back to Betty for \$40,000 "years later." Had the shares

been worth \$40,000 or anywhere in the ballpark of \$40,000 at the time of the agreement and the time Lucy provided her services, they would likely be considered both “unreasonable” and “unconscionable” under the circumstances. Lucy performed only 20 hours of work to obtain certain trademark advice. Although trademark advice may be a specialized field that might justify a “premium” fee, if Lucy were given stock worth \$40,000 to perform 20 hours of work, she would be receiving the equivalent of \$2,000 per hour for her work, a fee that would most likely be considered both “unreasonable” and “unconscionable.” Accordingly, unless the value of the shares grew significantly, the amount of the fee would be a violation of the rules of professional conduct.

However, it is not clear what the value was at the time the agreement was entered into or when the services were provided. The facts suggest that all 20 hours of service were provided before Lucy received the stock. If that is the case, and if the stock only had a value of roughly \$4,000 at that time, then the fee was not unreasonable or unconscionable, and the amount of the fee would not be a violation of the rules.

2. Lucy’s Report of ABC to the State Consumer Protection Agency

Attorneys owe their clients a duty of confidentiality. The duty of confidentiality requires a lawyer to keep confidential all information provided to the lawyer for the purpose of rendering legal services. The duty of confidentiality is necessary to ensure complete candor between clients and their attorneys, so as to facilitate effective legal advice. There are certain exceptions to the duty of confidentiality, such as when a lawyer is accused of malpractice, or is required to sue to collect a fee. Moreover, a lawyer who becomes aware that his or her client intends to commit an act that will cause great bodily injury or death may under certain circumstances disclose confidential information. Under the ABA Model Rules, a lawyer who is aware that a client intends to commit fraud that will cause significant financial injury can disclose confidential information to the extent

reasonably necessary to avoid the fraud if the lawyers' services were used in connection with the fraud. Under the California rules, there is no similar exception for information related to fraud.

Here, Lucy became aware that ABC had made certain representations that were false and misleading that caused customers to pay for services they would never receive. Although Lucy learned of these false and misleading representations during the course of her work for ABC, there is no indication that Lucy's services were used as part of any effort to mislead consumers.

A. Lucy's Report to Betty

Lucy properly reported her discovery to Betty. Under the ABA Model Rules, when a lawyer working for a business organization discovers misconduct that might damage the organization, he or she has an obligation to report that misconduct up the chain of authority within the organization. Under certain circumstances the lawyer may also be able to report that misconduct to the SEC if the organization is a reporting company and the CEO/CFO/CLO fail to act upon receiving the information. California permits but does not require a lawyer to report such misconduct "up the chain" and prohibits reporting it outside of the company, although with regard to securities law violations, federal law may preempt California law.

B. Lucy's Report to the State Consumer Protection Agency

However, it was a breach of Lucy's duty of confidentiality to ABC to report the misconduct to the State Consumer Protection Agency. Under the California rules, there is no exception to the duty of confidentiality to report fraud. Even under the ABA Model Rules, the exception would not apply here. As indicated above, Lucy's services were apparently not used to make the misrepresentations. Moreover, Lucy discovered evidence of past

misrepresentations in which consumers had already paid for services they would not receive. Therefore, it does not appear that disclosure of those past instances of misrepresentation were necessary to prevent or mitigate any further fraud.

3. Lucy's Representation of XYZ

A lawyer's duty of loyalty prohibits the lawyer from undertaking matters in which he or she has a conflict of interest except under certain circumstances. When a new client seeks to engage a lawyer in a matter involving a former client, the duties of loyalty and confidentiality are involved. A lawyer must not use confidential information obtained in a prior engagement in the new engagement. Generally, a lawyer may not undertake to represent a new client if there is a significant risk that representation of another client might have a material impact on the lawyer's ability to diligently and competently represent the new client. If a reasonable lawyer could conclude that he or she could undertake the subsequent representation without impact on the lawyer's ability to diligently represent the new client, and that the representation of the former client will not result in the use of any confidential information obtained in the prior engagement, the lawyer may undertake the new engagement so long as both clients are informed and [provide] consent in writing. The California rule is similar, but does not have a "reasonable lawyer" standard and requires only disclosures, not a signed consent.

Here, after completing her work for ABC and closing her file on that matter, Lucy is asked to represent Donna, in a trademark dispute with XYZ. Lucy has not previously had any attorney-client relationship with XYZ. It is true that XYZ is solely owned by Betty, the former president and shareholder of ABC, Lucy's former client, but corporations are separate legal persons. It is clear that Lucy's prior client was ABC, not Betty. The facts indicate that Betty engaged Lucy "on behalf of ABC." Moreover, Donna's dispute is with XYZ, not with Betty (or ABC). If ABC had merged or consolidated with XYZ, or if ABC had sold assets

(particularly its intellectual property, including any trademarks that Lucy was involved with) then it might be possible that Lucy would be in possession of confidential information belonging to ABC/XYZ that might be pertinent to her representation of Donna in her dispute with XYZ. However, the facts do not indicate this is the case, and assuming that XYZ is a separate company from ABC, there is no conflict of interest that would result in any ethical violation if Lucy undertakes the representation of Donna.

Answer B to Question 1

Financial Duties

Lawyers are governed by professional ethics in their practice of law. Lawyers have several duties to their clients, the court, the public, and the profession. One duty lawyers have to their clients is in the realm of finances. Such duties include the amount of fees and how fees may be charged to clients.

Fees

The ABA requires that fees must be reasonable, taking into account the lawyer's skill level, the amount of work involved in a case or matter, and the novelty of the service being provided.

In California, fees must not be unconscionable. Also, fee agreements must be in writing, unless the services are for a routine matter dealing with a business client or the matter is handled in an emergency situation.

It is permissible for lawyers to accept stock shares from clients in lieu of money payment, but the deal must be objectively reasonable to the lawyer and fair to the client at the time that it is made. However, in business dealings with clients, lawyers must only engage in a transaction so long as it is fair to the client and the client is advised to seek separate counsel before proceeding.

Fee Amount

In this case, Betty, as sole shareholder and owner of ABC, needed legal counsel in starting her business. Since she was short on cash, she offered to pay Lucy with stock shares, which would make Lucy a 1% shareholder in ABC. Lucy's regular fee is \$200 per hour and she ended up doing just 20 hours of work for

ABC. When Lucy eventually cashed in her shares, she earned \$40,000. The issue is whether this would be reasonable at the time the company was started and the deal between Lucy and Betty was formed.

The amount that Lucy eventually recovered was 10 times greater than the fees she would have collected in her work for ABC. Since Lucy probably had some idea of what the stocks were worth at the time she made this fee arrangement with ABC, it turns on whether the stock returns would have been unreasonable had Lucy sold the stocks around the time she made this arrangement. It is likely that the ABA rules may determine that a lawyer receiving a \$40,000 payment for \$4,000 of work is simply unreasonable. However, since the standard is whether it was reasonable and fair at the time of the contract or arrangement, Lucy may be able to show the stock prices spiked unexpectedly and that she did not act unfairly or unreasonably here.

In CA, however, the standard is unconscionability. Since ABC was a startup company and offered an online calendaring service, there are no facts to suggest that Lucy's receiving 1% of the stock would amount to a windfall, or even an unreasonable fee amount. In the case the company failed, Lucy would have received very little or nothing for her services. Since Lucy didn't know that the fees would be so out of proportion to her normal fees, the fee arrangement probably would not be deemed unconscionable in California and therefore would be upheld.

Fee Agreement

The other issue is that the fee arrangement was oral. In CA, all fee arrangements must be in writing, unless there is an emergent or routine matter being handled by the attorney. Since ABC is a new client, we have no reason to believe this work was routine. Also, it was not an emergency since Lucy merely

was handling some trademark work for ABC. Lucy should have reduced this fee agreement in writing.

Lucy also should have advised Betty to obtain separate counsel since the fee arrangement is tantamount to a business engagement between Lucy and Betty. That way, Lucy would protect herself and follow ethical rules by ensuring that Betty knew her rights and was prepared to continue with the fee arrangement, having received independent advice on the matter.

Duty of Confidentiality

Lawyers have an ethical duty to maintain confidential all communications related to the representation of their client. The source of the information is irrelevant to this duty, and the duty extends to clients even after representation has ended.

Should a lawyer receive information from or about a client that the client will be engaging in activity that poses serious risk of death or bodily harm to another, the ABA allows the lawyer to report this to authorities, notwithstanding the duty of confidence. In CA, the act must amount to a crime. In the case of financial crimes or fraud, CA does not permit reporting to authorities. In the ABA, reporting is allowed only if (a) the lawyer's services are being used to perpetrate the crime or fraud, and (b) reporting would prevent the financial crime from occurring.

Here, Lucy obtained confidences in her representation of ABC that were related to the representation; therefore she has a duty to maintain those confidences unless she is excused from that duty.

False Representations to Customers

In this case, Lucy learns that ABC is making certain false and misleading representations that caused customers to pay for services they would never receive. Here, this would amount to a financial fraud or crime since customers will be wrongfully led to believe they are receiving something they are not, after they turn over their money. In CA, Lucy may not report this to authorities such as the police or the District Attorney. In the ABA, Lucy may only report this to authorities if her services are used to commit the wrong, and she believes reporting will stop it.

Lucy only performed trademark work, so the likelihood that she was assisting in this fraudulent activity is slight. However, Lucy may argue that, without the trademark, the company couldn't have started [the] business, so she is responsible for assisting. Lucy could prevent the crime if she told authorities and ABC was required to stop operations or refund customer funds.

Reporting Up and Reporting Out

The ABA authorities permit attorneys to report within the corporation to higher authorities if they suspect wrongdoing or fraud. The ABA also allows attorneys to report to outside authorities, such as the SEC, for securities violations or fraud within a corporation. In CA, again, only reporting within is allowed. Reporting out is not allowed in any case; however, if the federal law requires or allows an attorney to report, federal preemption means she cannot be held liable for that.

Here, Lucy reported up when she told Betty of her concerns. However, this was probably futile since Betty is the sole shareholder and president of the company, and told Lucy to ignore what she had discovered. Lucy then went to the State Consumer Protection Agency. In the ABA, this would be permitted. And, if it were a federal agency, Lucy would be permitted to report out if the agency so

required. However, in CA, Lucy is not permitted to report out to prevent financial crime. The ethical rules in CA prohibit Lucy from doing anything but discussing her concerns with Betty. Since the agency she reported to was state-governed, and not federal, Lucy will be subject to discipline for violating her duty of confidentiality to ABC and to Betty.

Withdrawal

If an attorney's services are used to perpetrate a crime or a fraud, they must make [an] attempt to withdraw from the representation; this is mandatory withdrawal. Permissive withdrawal means that Lucy could attempt to withdraw from the representation if she finds the client's wishes or activities to be morally repugnant. If Lucy withdraws, she must provide timely notice to Betty and must return all materials obtained during the representation. She also must not divulge any confidences since the duty of confidentiality persists indefinitely.

Duty of Loyalty

Lawyers owe their clients a duty of loyalty. This means that if there is a conflict with the lawyer and the client, a past client, or any third party that materially limits the lawyer's ability to effectively represent the client, she must not take the representation or withdraw from it. Some conflicts can be waived upon informed consent from the client. In CA, this consent must be in writing.

In CA, the lawyer must be able to effectively represent their client. The ABA requires that the lawyer "reasonably believe" she can effectively represent the client, notwithstanding conflicts. This is an objective test and the lawyer's actions will be judged objectively. Therefore, representation of one client that compromises the confidences of another may make consent impossible, and would make representing both parties unreasonable.

Past Client Conflicting with Present Client

If a lawyer has represented a client in the past who is now on the opposing side in litigation, representation of the new client may still be permitted if written consent is obtained from the former client, and the lawyer may represent each client effectively without compromising her duties of confidence and loyalty to both. However, if the subject matter of the litigation is similar to the past representation of the former client, this will be deemed unreasonable and therefore a non-consentable conflict.

Lucy's Representation of Donna

Lucy represented ABC on trademark work. ABC has been sold, but Betty, the essential founder and controller of ABC, has now started a new company, XYZ. The work Lucy performed for Betty is regarding the same matter currently at issue in her representation of Donna—trademarks. However, it may not be related to anything that Lucy handled for ABC in the past, and, so, even though it is the same nature of work, it may not directly relate to her work with ABC.

Now, Lucy seeks to represent Donna, her new client, in an action against XYZ. Since XYZ is essentially run by Betty, Lucy must get consent by Betty to represent Donna. However, Donna must also be informed about the conflict. Lucy knows confidential information regarding misrepresentations [of] ABC, and, therefore, Betty, has made in the past. Since she may not reveal this information to Donna, Donna cannot be informed fully about how Lucy's representation may harm her. She may not understand fully the reasons behind the conflict, and therefore, consent is not possible.

Since Lucy cannot obtain fully informed consent from Donna, she must not take Donna's case and should withdraw.