



CHAPTER ONE — COUNSELING OF SMALL BUSINESS CLIENTS

Competent Counseling of Small Business Clients

BY HARRY J. HAYNSWORTH, IV

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Introduction

Virtually all practicing lawyers counsel small business clients.¹

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The following citations will be used in this article:

i. AMERICAN BAR ASS'N, CODE OF PROFESSIONAL RESPONSIBILITY (1978) will be cited as ABA CODE. It is referred to in the text as the Code of Professional Responsibility or CPR. The Disciplinary Rules ("DR") and Ethical Considerations ("EC") will be cited only to the DR and EC numbers in the ABA Code.

ii. American Bar Ass'n, Committee on Professional Ethics Formal and Informal Opinions are cited as ABA FORMAL OPINION and ABA INFORMAL OPINION.

iii. American Bar Ass'n, Commission on Evaluation of Professional Standards Model Rules of Professional Conduct—Discussion Draft (1980) will be cited as the PROPOSED MODEL RULES. Page references are to the ABA Discussion Draft published January 30, 1980. The Proposed Model Rules have also been published as a Special Supplement in 48 U.S.L.W., No. 48 (Feb. 19, 1980).

iv. R. MALLEEN & V. LEVIT, LEGAL MALPRACTICE (1977) will be cited as MALLEEN & LEVIT.

¹ For example, a study of New York City lawyers revealed that more lawyers specialize in business law than in any other area. See J. CARLIN, LAWYERS ETHICS 11-13 (1966). Seventy percent of all lawyers in Manhattan and the Bronx earn at least half of their income from business clients. *Id.* at 13. At least 75% of these business law practitioners usually represent small to medium sized businesses. *Id.*

There is no universally-accepted definition of a "small business." For the Small Business Administration's proposed uniform definition, see 45 Fed. Reg. 15442-53 (1980). Nevertheless, the vast majority of business entities are small businesses. Characteristically, small businesses have a limited number of participants, most or all of whom are active in the business. One authority estimates that approximately 95% of all corporations have 10 or fewer shareholders, 99% have 100 or fewer shareholders and the median United States corporation has assets of \$100,000 and three shareholders. Conrad, *The Corporate Census: A Preliminary Exploration*, 63 CALIF. L. REV. 440, 458-59, 462 (1975). Recent statistics indicate that approximately 97% of all business enterprises are small businesses. Such companies employ over one-half of the employees in private industry and produce about one-half of the national indus-

Counseling involves a broad spectrum of legal functions ranging from advising clients regarding proposed transactions, preparing legal opinions and interpreting contracts and other legal documents to negotiating disputes that have not ripened into lawsuits and, at times, acting as an intermediary between two or more clients. A distinction between a lawyer's role as a counselor-advisor and as a litigator has long been recognized,² and both the ABA Code of Professional Responsibility (CPR)³ and the recent Proposed Model Rules of Professional Conduct⁴ in-

trial output. *Hearings before the Select Committee on Small Business of the United States Senate*, 95th Cong. 2d Sess., Pt. 1 at 93 (1978); UNITED STATES SMALL BUSINESS ADMINISTRATION, *SMALL ENTERPRISE IN THE ECONOMY* (1978).

² See, e.g., *Professional Responsibility: Report of The Joint Conference*, 44 A.B.A.J. 1159 (1958). A recent, perceptive analysis of the differences in the two roles is contained in Schwartz, *The Professionalism and Accountability of Lawyers*, 66 CALIF. L. REV. 669 (1978).

³ The ABA Code, adopted by the American Bar Association in 1969, replaced the Canons of Ethics originally adopted in 1908. With modifications, the ABA Code has been adopted in every state. ABA STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY, *CODE OF PROFESSIONAL RESPONSIBILITY BY STATE* (1977). The California Rules of Professional Conduct, effective January 1, 1975, represent the most radical departure from the ABA Code. See RULES OF PROFESSIONAL CONDUCT OF THE STATE BAR OF CALIFORNIA, *reprinted in* 3B WEST'S ANN. CAL. CODES, BUS. & PROF. CODE, Rules 1-100 through 8-101, (West Cum. Supp. 1980)(hereinafter referred to as CALIFORNIA RULES OF PROFESSIONAL CONDUCT)

The ABA Code is divided into three parts: Canons, which are axiomatic norms of conduct; Ethical Considerations (EC), which are standards toward which all lawyers should aspire; and Disciplinary Rules (DR), which are minimum standards of conduct violation of which subjects an attorney to possible disciplinary action. ABA CODE, *Preliminary Statement*. The dichotomy between the binding character of the Disciplinary Rules and the aspirational nature of the Ethical Considerations is not rigid. The Ethical Considerations often elaborate, limit or define the scope of the Disciplinary Rules to which they relate. Compare, e.g., EC 5-14 to 5-20 with DR 5-105 and 5-106; and see Committee on Prof. Ethics & Conduct v. Behnke, 276 N.W. 2d 838 (Iowa 1979), cert. denied, 100 S.Ct. 27 (1979)(three year suspension for violation of EC 5-5 upheld).

⁴ The Proposed Model Rules abandon the three tiered format of the ABA Code in favor of Rules, setting forth a lawyer's ethical responsibilities, followed by explanatory Comments. If approved by the ABA House of Delegates, the Proposed Model Rules will replace the ABA Code. The earliest date for final approval of the Proposed Model Rules is August, 1981. The Proposed Model Rules will not be binding on lawyers for disciplinary purposes, however, unless and until they are adopted by the States.

corporate salient features of this distinction.⁵

Sometimes the client's counseling request will involve a straightforward question of law any recent law school graduate should be able to handle easily. Increasingly, however, even fairly routine matters, such as forming a new business, involve many different fields of law.⁶ Frequently, adequate counseling on business matters requires knowledge of antitrust, Uniform Commercial Code, bankruptcy, and employment law and involve one or more of the federal and state administrative regulations that have proliferated in recent years. Clients also often have problems involving patents, trademarks, copyrights or trade secrets. This list, although appearing to read like a list of law school curriculum, is far from exhaustive.

Knowledge of all the applicable law is a difficult but not insurmountable task. Knowing the correct legal principles is usually only a starting point, however. Relatively few legal questions presented to lawyers have clearcut answers. Most are in the grey area. In many cases there are several alternatives that will achieve the client's business objectives, each involving some legal risks. Often, important business factors should be considered before a final decision is made. The proper role of a lawyer in counseling a client with respect to these non-legal risks is controversial.⁷

⁵ The ABA Code recognizes four major differences in the litigation and counseling roles. A litigator must for the most part deal primarily with past facts, whereas a counselor often has the power to structure or alter a future transaction to avoid legal pitfalls. Second, a litigator is entitled to resolve all doubts about the propriety of the client's action in favor of the client and may advocate any legal position that is not frivolous or without some legitimate legal support, whereas a counselor has a more definite obligation to advise and disclose to the client the ultimate legal results of the client's objectives. Third, the circumstances under which a lawyer can withdraw from representation are more restrictive once a case involves litigation. Finally, the rules regarding disqualifying conflicts of interest are less restrictive in counseling situations. See DR 2-110; EC 5-16, 5-17 and DR 5-105; EC 7-3 through 7-5 and 7-8.

The Proposed Model Rules refine this distinction even further. They contain separate sets of rules for an advocate, adviser, negotiator, intermediary and legal evaluator. See PROPOSED MODEL RULES 2,3,4,5, &6.

⁶ For example, advice on what type of legal format a new business should take must include, in addition to knowledge of the legal attributes of proprietorships, partnerships, the various types of corporations and other business forms, consideration of tax and securities laws and regulations. See notes 137-39 and accompanying text *infra* for further discussion of this point.

⁷ See, e.g., *Panel Discussion—A Businessman's View of Lawyers*, 33 Bus.

Complexity and uncertainty are not the only difficulties facing the small business legal counselor. Perhaps the most dramatic legal development in recent years has been the increase in the number of legal malpractice claims and disciplinary actions filed against lawyers.⁸ A significant number of these actions involved the failure of a counseling lawyer to represent the client's interest loyally⁹ and diligently¹⁰ and to know or to apply the applicable law in a skillful manner.¹¹ Some involve fraudulent¹² or criminal¹³ conduct. Most, however, involve claims based essen-

LAW. 817 (1978); deButts, *Client's View of Lawyer's Proper Role*, 33 BUS. LAW. 1177 (1978); Redlich, *Should A Lawyer Cross The Murky Divide?*, 31 BUS. LAW. 478 (1975). See Part II(D)(4) *infra* for further discussion of this issue. For a more philosophical analysis, see Fried, *The Lawyer As Friend: The Moral Foundations of the Lawyer-Client Relation*, 85 YALE L.J. 1060 (1976); Lehman, *The Pursuit of a Client's Interest*, 77 MICH. L. REV. 1078 (1979).

⁸ See, e.g., Avery, *Significant Current Trends Affecting Malpractice Liability In The Fields of Real Property, Probate and Trust Law*, 13 REAL PROP. & TRUST J. 154 (1978)(from January 1975 through June 1977, 15 malpractice appellate opinions were filed in California and 36 were filed in other states). Martin, *Lawyer's Professional Liability—A Developing Crisis?*, 43 INS. COUNSEL J. 532 (1976); Steele & Nimmer, *Lawyers, Clients, and Professional Regulation*, 1976 AM. B.F. RES. J. 919, 933-49.

In the four year period from 1974-1977, the number of lawyers publicly disciplined increased approximately 20%. STANDING COMM. OF PROF. DISCIPLINE & CENTER FOR PROF. DISCIPLINE OF THE AM. BAR ASS'N, STATISTICAL REPORT RE: PUBLIC DISCIPLINE OF LAWYERS BY STATE DISCIPLINARY AGENCIES, 1974-1977, DISCIPLINARY LAW AND PROCEDURE RESEARCH SYSTEM.

⁹ See, e.g., *Rowan v. Le Mars Mutual Ins. Co.*, 282 N.W.2d 639 (Iowa 1979)(civil liability); *In re Banks*, 283 Ore. 459, 584 P.2d 284 (1978)(public reprimand).

¹⁰ See, e.g., *People v. Van Nocker*, 176 Colo. 354, 490 P.2d 697 (1971)(indefinite suspension for failure to file client's tax returns). *Stewart v. Sbarro*, 142 N.J. Super. 581, 362 A.2d 581 (1976)(malpractice liability for delay in obtaining signatures on legal documents).

¹¹ See, e.g., *Smith v. Lewis*, 13 Cal. 3d 349, 530 P.2d 589, 118 Cal. Rptr. 621 (1975)(malpractice liability for lack of legal knowledge); *State ex. rel. Neb. State Bar Ass'n v. Holscher*, 193 Neb. 729, 230 N.W.2d 75 (1975)(public reprimand for failure to discover statute).

¹² See, e.g., *Capital Bank & Trust Co. v. Core*, 343 So. 2d 284 (La. Ct. of App. 1977)(no malpractice insurance coverage for fraudulent failure to certify a title properly); *Maryland State Bar Ass'n v. Sugarman*, 273 Md. 306, 329 A.2d 1, *cert. denied*, 420 U.S. 974 (1974) (disbarment for aiding and abetting in the evasion of income taxes).

¹³ See, e.g., *United States v. Benjamin*, 328 F.2d 854 (2d Cir. 1964), *cert. denied*, 377 U.S. 953 (1964)(criminal sanctions for securities laws violations); *In re Lytton*, 48 Ill. 2d 390, 270 N.E.2d 32 (1971)(three year suspension follow-

tially on alleged negligent conduct by lawyers.¹⁴ When filed as private lawsuits, these claims are generally categorized as civil malpractice actions.¹⁵ In contrast, claims based on the same set of facts filed with a disciplinary agency are generally handled as potential violations of either the ethical rules governing conflicts of interest or competence.¹⁶

Suits against lawyers based on violation of the federal securities laws have received more notoriety than any other type of violation.¹⁷ In addition to a growing number of private damage actions,¹⁸ the Securities and Exchange Commission has aggressively sought court injunctions¹⁹ and administrative disciplinary sanctions against lawyers under Rule 2(e) of the Commission's Rules of Practice.²⁰ Most securities cases against lawyers involve

ing *nolo contendere* plea to securities law violation).

¹⁴ See the authorities in note 8 *supra*.

¹⁵ See MALLIN & LEVIT §§ 71-103.

¹⁶ Although the ethical rules regarding competence and conflicts of interest are generally considered as being distinct, in this article the use of the term "competence" is used in the broader malpractice sense as encompassing both violation of an attorney's fiduciary duty of loyalty to the client as well as lack of legal knowledge and skill.

¹⁷ See, e.g., Gruenbaum, *Corporate Securities Lawyers: Disclosure Responsibility, Liability to Investors and National Student Marketing Corp.*, 54 NOTRE DAME LAW. 795 (1975); Lorne, *The Corporate and Securities Adviser The Public Interest, and Professional Ethics*, 76 MICH. L. REV. 423 (1978); Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974). Sommer, *The Emerging Responsibilities of the Securities Lawyer*, [1973-74 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,631, at 83,689.

¹⁸ E.g., *Fiet v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

¹⁹ E.g., *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978).

²⁰ 17 C.F.R. § 201.2(e)(1979). Although in effect since 1935, only five 2(e) cases were brought against lawyers before 1960. In the 1970's in excess of 85 were filed. In re Keating, Meuthing & Klehamp, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,994 (dissent of Commissioner Karmel). For discussion of the operation of Rule 2(e), see, e.g., Daley and Karmel, *Attorney's Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747 (1975); Johnson, *The Dynamics of SEC Rule 2(e): A Crisis for the Bar*, 1975 UTAH L. REV. 629; Comment, *Attorney Liability Under SEC Rule 2(E): A New Standard?*, 11 TEXAS TECH. L. REV. 83 (1979).

the anti-fraud provisions of the securities acts.²¹ These provisions apply to all purchases and sales of securities by any size company and not merely to distributions by large publicly held companies. Questions concerning the qualification of a securities transaction under the various securities acts exemptions are often a central issue in these cases.²² Thus, unless a small business practitioner refuses to handle any legal problems involving the issuance or distribution of a security—which is a practical impossibility—he or she will have to cope with the intricacies of the securities laws. In doing so the practitioner will be exposed to a wide range of potential sanctions available under such laws.

While suits against lawyers for their securities law counseling have received the lion's share of publicity, there have also been a considerable number of successful claims against lawyers in other counseling contexts commonly engaged in by practitioners representing small businesses. In addition to being held liable for directly or indirectly participating in, or aiding and abetting a client's fraudulent or criminal conduct,²³ attorneys have been disciplined or held liable in a malpractice action in a wide variety of situations involving failure to represent clients compe-

²¹ Most of the cases have involved alleged violations of Section 10 and Rule 10b-5 of the 1934 Securities Act. 15 U.S.C. § 78j(b) (1976) and 17 C.F.R. § 240.10b-5 (1979). Provisions of the Securities Act of 1933 often invoked in these cases include sections 11, 12(2) and 17(a). 15 U.S.C. § 77k, 77l(2), & 77q (1976). See generally Cheek, *Professional Responsibility and Self Regulation of the Securities Lawyer*, 32 WASH. & LEE L. REV. 597 (1975). Ruder, *Multiple Defendants In Securities Law Fraud Cases: Aiding and Abetting Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972).

²² See, e.g., SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978) (section 17(a) liability based in part on unsubstantiated opinion letter); SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); SEC v. Frank, 388 F.2d 486 (2d Cir. 1968). A lawyer's ethical responsibilities with respect to the scope of proper investigation prior to issuing a securities opinion letter are discussed in ABA Formal Opinion 335 (1974). One commentator has suggested that the duty of verifying facts prior to issuing a securities opinion letter may be greater than in a case involving a review of a registration prospectus because the burden on the attorney is not as onerous in the opinion situation. Note, 87 HARV. L. REV. 1860, 1869-70 (1974). See generally Landau, *Legal Opinions Rendered in Securities Transactions*, EIGHTH ANNUAL PLI INSTITUTE ON SECURITIES REGULATION 11 (1976).

²³ See, e.g., United States v. Kelley, 105 F.2d 912 (2d Cir. 1939); Maryland State Bar Ass'n v. Sugarman, 273 Md. 306, 329 A.2d 1, cert. denied, 420 U.S. 974 (1974); In re Brodrick's case, 181 A.2d 647 (N.H. 1962).

tently. Examples of lawyer incompetence include: (1) failure to know or to investigate fully the law in a particular area prior to advising a business client of its legal rights and obligations;²⁴ (2) failure to investigate properly the facts prior to advising the client;²⁵ (3) failure to interpret clearly established legal principles correctly;²⁶ (4) failure to file properly documents required to be filed;²⁷ (5) failure to take timely action to avoid prejudice to the client;²⁸ (6) failure to disclose fully to the client factual and legal information the client is entitled to have before deciding to employ the attorney or before deciding what course of action to take;²⁹ and (7) failure to refuse representation or voluntarily to discontinue representation when a disqualifying conflict of interest exists.³⁰ In addition a number of cases have denied attorneys their fees³¹ and have held contracts drafted by attorneys unenforceable³² as a result of one or more of these or similar acts of incompetence. Furthermore, in recent years courts have with increased regularity refused to sustain a defense in malpractice actions based on lack of privity.³³ As a result, suits by third par-

²⁴ See, e.g., *Smith v. Lewis*, 13 Cal. 3d 349, 530 P.2d 589, 118 Cal. Rptr. 621 (1975).

²⁵ See, e.g., *Owen v. Neely*, 471 S.W.2d 705 (Ky. 1971).

²⁶ See, e.g., *Ward v. Arnold*, 52 Wash. 2d 581, 328 P.2d 164 (1958).

²⁷ See, e.g., *Schwartz v. Greenfield*, Stein & Weisenger, 90 Misc. 2d 882, 396 N.Y.S.2d 582 (1977).

²⁸ See, e.g., *House v. Maddox*, 46 Ill. App. 3d 68, 360 N.E.2d 580 (1977); *Hoppe v. Ranzini*, 158 N.J. 158, 385 A.2d 913 (1978)(excellent review of damages in various types of malpractice actions).

²⁹ See, e.g., *Spector v. Mermelstein*, 361 F. Supp. 30 (S.D.N.Y. 1972), *rev'd on other grounds*, 485 F.2d 474 (2d Cir. 1973).

³⁰ See, e.g., *Lysick v. Walcom*, 258 Cal. App. 2d 136, 65 Cal. Rptr. 406 (1st Dist. 1968); *Ishmael v. Millington*, 241 Cal. App. 2d 520, 50 Cal. Rptr. 592 (1966).

³¹ See, e.g., *In re Estate of Gould*, 547 S.W.2d 863 (Mo. App. 1977); *Anderson v. Eaton*, 211 Cal. 113, 293 P. 788 (1930). Some statutes authorize the assessment of attorney's fees to be paid by the offending lawyer. See, e.g., CAL. CIV. PROC. CODE § 2034(d) (West Cum. Supp. 1980)(improper refusal to answer interrogatories); CAL. CIV. PROC. CODE § 907 (West Cum. Supp. 1980)(filing a frivolous appeal); *Metzger v. Silverman*, 62 Cal. App. 3d Supp. 30, 133 Cal. Rptr. 355 (1976). See generally Comment, *Sanctions Imposed by Courts on Attorneys Who Abuse the Judicial Process*, 44 U. CHI. L. REV. 619 (1977).

³² See, e.g., *Crest Investment Trust, Inc. v. Comstock*, 23 Md. App. 280, 327 A.2d 891 (1974).

³³ California courts have been in the forefront in this area. See, e.g., *Biakanja v. Irving*, 49 Cal. App. 2d 647, 320 P.2d 16 (1958). *Morales v. Field, De Goff, Huppert & MacGowan*, 99 Cal. App. 3d 307, P.2d, 160 Cal. Rptr. 239

ties claiming reliance on alleged legally or factually incorrect legal opinions are increasingly more common.³⁴

In short, increased complexity, uncertainty, and exposure to ethical and malpractice sanctions characterize the milieu in which the small business practitioner must operate.

While some lawyers represent business clients exclusively, most lawyers do so in the context of being a general practitioner.³⁵ Many of these will receive a considerable portion of their total fees from business clients and might thus be classified as *de facto* business law specialists. Nevertheless, a considerable number of practitioners represent small business clients on only an occasional basis. Whatever the percentage of total time devoted to counseling small business clients, however, no practitioner, even the full time specialist, is foolish enough to claim expertise in all areas of law that may affect his or her small business clients.

At this juncture several questions come readily to mind. Is it really possible to represent a small business client competently? Are lawyers held to a higher standard in counseling than in performing litigation services for small business clients? Are general

(1st Dist. 1979). Several other states have adopted the California rationale. *See, e.g.*, *Stewart v. Sbarro*, 142 N.J. Super. 581, 362 A.2d 581 (1976); *Schwartz v. Greenfield, Stein and Weisinger*, 90 Misc. 2d 882, 396 N.Y.S. 2d 582 (1977). *But see Chalpin v. Brennan*, 114 Ariz. 124, 559 P.2d 680 (1979). *See generally* MALLEN & LEVIT §§ 53-59; Annot., 45 A.L.R.3d 1181 (1972) Annot., 34 A.L.R.3d 1122 (1970); Annot., 65 A.L.R.2d 1363 (1959).

³⁴ *See, e.g.*, *Collins v. Fitzwater*, 277 Or. 401, 560 P.2d 1074 (1977) (purchasers of securities allowed to recover against attorney for improper securities opinion on indemnification and malpractice theory). *But see Goodman v. Kennedy*, 18 Cal. 3d 335, 556 P.2d 737, 134 Cal. Rptr. 375 (1976) (no liability because purchasers of stock from officers of a corporation were not legally entitled to rely on a legal opinion rendered to officers that stock dividends were exempt from registration).

A similar theory justifies direct recovery of damages by shareholders against a corporation's attorney in a derivative action. *See, e.g.*, *Rowan v. Le Mars Mutual Ins. Co.*, 282 N.W.2d 639 (Iowa 1979) (attorney for insurance company forced to disgorge all attorney's fees and held liable individually for punitive damages of \$25,000 in addition to share of other damages). The rights of limited partners to sue the partnership's attorney are more restricted. *See Amsler v. American Home Assurance Co.*, 348 So.2d 68 (Fla. Ct. App. 1977); *but see Browning v. Maurice B. Levien & Co., P.C.*, — N.C. App. —, 262 S.E.2d 355 (1980) (limited partners allowed to sue partnership's architect for improper issuance of architect's certificate).

³⁵ *See J. CARLIN, supra* note 1, at 11-13.

practitioners who counsel small business clients held to the same standard as specialists who represent business clients almost exclusively? Is there any difference in the required standard of competence between lawyers who represent small business clients on a regular basis and those that represent them only on an occasional basis? What standard of competence is applicable when an attorney performs counseling services for a small business client in areas where he lacks experience or expertise? What are the most prevalent conflict of interest problems encountered representing small business clients? Should a lawyer hold an office or invest in a small business client? What action can the small business practitioner take to minimize the danger that he or she will be sanctioned for incompetent counseling?

This article grapples with these and related knotty questions. The major conclusions reached are: first, that the minimum standard of competence is probably more exacting than most practitioners realize and is gradually being raised by a combination of court decisions and actions taken by disciplinary agencies; second, lawyers will be held to the standard of care applicable to a specialist if they undertake legal services that properly should be handled by a specialist in the area; third, courts are sensitive to the difficulties faced by lawyers in advising clients and have not imposed sanctions where lawyers have diligently investigated the facts and applicable law and then made all required disclosures to the client, even if the advice turns out to be incorrect; fourth, practitioners need to develop more sensitivity to the potential conflict problems that commonly arise in representing small businesses, especially problems resulting from representation of multiple clients; and fifth, almost all of the successful claims would not have arisen had the attorneys involved followed basic, well recognized law office management techniques and common sense.

I. THE INTERRELATION BETWEEN MALPRACTICE AND DISCIPLINARY ACTIONS

Although incompetent representation has long been recognized as grounds for a malpractice action,³⁶ until quite recently

³⁶ See, e.g., *Citizens Loan Fund & Sav. Ass'n. v. Friedley*, 123 Ind. 143, 23 N.E. 1075 (1890); *Hill v. Mynatt*, 59 S.W. 163 (Tenn. 1900). See generally Haughey, *Lawyers' Malpractice: A Comparative Appraisal*, 48 NOTRE DAME LAW. 888 (1973); Wade, *The Attorney's Liability for Negligence*, 12 VAND. L.

courts have been reluctant to impose disciplinary sanctions for incompetence.³⁷ Disciplinary Rule 6-101 to Canon 6 of the CPR, however, contains explicit provisions authorizing discipline for lack of competence.³⁸ Although there have not been many pub-

REV. 775 (1959); Wilkins, *Malpractice and the Underinformed Lawyer, Or, What you Don't Know May Really Hurt You After All*, 44 INS. COUNSEL J. 333 (1977); Comment, *New Developments In Legal Malpractice*, 26 AM. U.L. REV. 408 (1977).

³⁷ See, e.g., *Friday v. State Bar*, 23 Cal. 2d 501, 505-06, 144 P.2d 564, 567 (1943); *Bryant's case*, 24 N.H. 149, 158 (1851)(ignorance of the law is not grounds for disbarment since the statutes regulating lawyers do not specifically require knowledge of the law); Note, *Negligence or Incompetence of an Attorney as Grounds for Disbarment or Suspension*, 30 NOTRE DAME LAW. 273, 278-79 (1955). The one exception involved cases where an attorney was excessively dilatory in handling client matters. See, e.g., *In re Spanckeren*, 81 Ariz. 55, 299 P.2d 643 (1956) (indefinite suspension for 21 year delay in handling an estate); *In re Lanza*, 24 N.J. 191, 131 A.2d 497 (1957)(three month suspension for delay in prosecuting a lawsuit).

³⁸ Canon 6 of the ABA Code states that "A Lawyer Should Represent a Client Competently." DR 6-101 is entitled "Failing to Act Competently" and states:

(A) A Lawyer shall not:

- (1) Handle a legal matter which he knows or should know that he is not competent to handle, without associating with him a lawyer who is competent to handle it.
- (2) Handle a legal matter without preparation adequate in the circumstances.
- (3) Neglect a legal matter entrusted to him.

Nothing equivalent to Canon 6 and DR 6-101 was included in the Canons of Ethics, approved by the American Bar Association in 1908. The closest equivalent was Canon 21 which required a lawyer "to be punctual in attendance, and to be concise and direct in the trial and disposition of causes."

For a discussion of DR 6-101, See ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY 262-72 (1979); Gaudineer, *Ethics and Malpractice*, 26 DRAKE L. REV. 88 (1976); and Thode, *Canons 6 and 7: The Lawyer-Client Relationship*, 48 TEXAS L. REV. 367 (1970). The problems of litigation competency have been the subject of considerable written comment in recent years. See, e.g., Bazelon, *The Defective Assistance of Counsel*, 42 U. CIN. L. REV. 1 (1973); Burger, *The Special Skills of Advocacy: Are Specialized Training and Certification of Advocates Essential To Our System of Justice?*, 42 FORDHAM L. REV. 227 (1973); Steinberg, *The Disciplinary Rules and Competence of Counsel: A Proposed Alternative*, 11 GONZ. L. REV. 133 (1975).

Alabama, Arizona, California, Florida, Idaho, Montana, New Jersey, Texas and Virginia have modified the official ABA text of DR 6-101. See CODE OF PROFESSIONAL RESPONSIBILITY BY STATE (1977). The California version differs substantially from the ABA Code. Rule 6-101 of the CALIFORNIA RULES OF PROFESSIONAL CONDUCT, *supra* note 3, states:

lished disciplinary decisions involving Canon 6,³⁹ the reported cases indicate that disciplinary agencies and courts apply the Canon and related Disciplinary Rules in a strict fashion.⁴⁰

The impact of Canon 6 cannot be measured, however, solely by the number of disciplinary cases in which it has been invoked. The Preliminary Statement to the CPR states that it does not "define standards for civil liability of lawyers for professional conduct."⁴¹ Canon 6 and DR 6-101, however, have frequently been used not to create a new cause of action where none previously existed,⁴² but rather as evidence of the required standard of competence.⁴³ Likewise, the rules regarding the ap-

A member of the State Bar shall not wilfully or habitually:

(1) Perform legal services for a client or clients if he knows or reasonably should know that he does not possess the learning and skill ordinarily possessed by lawyers in good standing who perform, but do not specialize in, similar services practicing in the same or similar locality and under similar circumstances unless he associates or, where appropriate, professionally consults another lawyer who he reasonably believes does possess the requisite learning and skill;

(2) Fail to use reasonable diligence and his best judgment in the exercise of his skill and in the application of his learning in an effort to accomplish, with reasonable speed, the purpose for which he is employed.

The good faith of an attorney is a matter to be considered in determining whether acts done through ignorance or mistake warrant imposition of discipline under Rule 6-101.

³⁹ See ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY 264-69 (1979).

⁴⁰ See, e.g., Louisiana State Bar Ass'n v. Gremillion, 320 So. 2d 171 (La. 1975)(disbarment for among other acts an improper title opinion, defense based on ignorance of real estate law summarily dismissed); People v. Yoakum, 191 Colo. 269, 552 P.2d 291 (1976) (disbarment for incompetent misrepresentation of business clients). State ex. rel. Neb. State Bar Ass'n v. Holscher, 193 Neb. 729, 230 N.W.2d 75 (1975) (public reprimand for overlooking statute).

⁴¹ ABA CODE, *Preamble and Preliminary Statement*.

⁴² See Bickel v. Mackie, 447 F. Supp. 1376, 1383-84 (N.D. Iowa 1978), *aff'd mem.*, 590 F.2d 341 (8th Cir. 1978); Bush v. Morris, 123 Ga. App. 497, 181 S.E.2d 503 (1971).

⁴³ See, e.g., Armstrong v. McAlpin, 606 F.2d 28, 30 (2d Cir. 1979)("While the standards of conduct governing attorneys practicing in the federal courts are ultimately matters for oversight by the federal judiciary, the American Bar Association's Code of Professional Responsibility has been recognized in this Circuit as a principal source of pertinent guidance"); Woodruff v. Tomlin, 593 F.2d 33 (6th Cir. 1979), Kirsch v. Duryea, 21 Cal. 3d 303, 578 P.2d 935, 146 Cal. Rptr. 218 (1978); Ishmael v. Millington, 241 Cal. App. 2d 520, 50 Cal. Rptr. 592 (3d Dist. 1966). See generally Wolfram, *The Code of Professional*

propriate level of competence required to defeat a malpractice claim have influenced disciplinary decisions involving claims of incompetence.⁴⁴

In spite of considerable differences in procedural and evidentiary requirements,⁴⁵ the standard of competence necessary to

Responsibility As A Measure of Attorney Liability in Civil Litigation, 30 S. CAROLINA L. REV. 281 (1979).

Since disciplinary proceedings are designed primarily to deal with the most serious type of unethical behavior and have been criticized for failing to fulfill that function adequately, the use of malpractice actions as a means of enforcing ethical standards may, in the long run, provide more effective regulation of lawyer conduct. See AMERICAN BAR ASS'N SPECIAL COMMITTEE ON EVALUATION OF DISCIPLINARY ENFORCEMENT, PROBLEMS AND RECOMMENDATIONS IN DISCIPLINARY ENFORCEMENT (1970) (The well known Clark Commission Report which analyses the defects in disciplinary enforcement); Marks & Cathcart, *Discipline Within the Legal Profession: Is it Self-Regulation?*, 1974 U. ILL. L.F. 193; Steele & Nimmer, *Lawyers, Clients, Professional Regulation*, 1976 AM. B.F. RES. J. 917; Wolfram, *The Code of Professional Responsibility As A Measure of Attorney Liability in Civil Litigation*, *supra* this note, at 288-95.

Disciplinary actions do have an *in terrorem* effect on other lawyers but the rapid increase in legal malpractice claims may have an even more immediate impact on lawyer's conduct. The concluding section of this article contains suggestions for reducing the risk of successful claims under either type of action.

⁴⁴ See, e.g., *Ames v. State Bar*, 8 Cal. 3d 910, 506 P.2d 625, 106 Cal. Rptr. 489 (1973); see also ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY 267-69 (1979); MALLEN & LEVIT § 92, Gaudineer, *Ethics and Malpractice*, 26 DRAKE L. REV. 88, 101-13 (1976). But see *Committee on Legal Ethics v. Mullins*, 226 S.E.2d 427 (W. Va. 1976) (court expressed concern that the disciplinary commission went too far in determining whether the complainants had a cause of action for legal malpractice).

⁴⁵ The major differences are as follows:

(1) While it is presently unsettled whether the tort or contract statute of limitations applies and when the statute begins to run, it is firmly established that a malpractice action can clearly be time barred by the applicable limitation statute. See MALLEN & LEVIT §§ 191-210. In contrast, delay in bringing a disciplinary action is not a defense unless actual prejudice to the accused attorney exists. See, e.g., *Caldwell v. State Bar*, 13 Cal. 3d 488, 531 P.2d 785, 119 Cal. Rptr. 217 (1975) (9 years); *In re Bossou*, 60 Ill. 2d 439, 328 N.E.2d 309, *cert. denied*, 433 U.S. 938 (1975); *In re Sarbone*, 63 N.J. 94, 304 A.2d 734 (1973) (10 years).

(2) A plaintiff's recovery in a malpractice action, due to its tort origins, requires "but for" causation, proximate cause and damages. See, e.g., *Hurd v. Dimento and Sullivan*, 440 F.2d 1322 (1st Cir.), (plaintiff must prove he would have recovered had the attorney not been guilty of malpractice); *cert. denied*, 404 U.S. 869 (1971) *Conley v. Leiber*, 97 Cal. App. 3d 646, 158 Cal. Rptr. 770 (4th Dist., 1979) (judgment in favor of law firm in a malpractice action upheld on grounds that failure to file a limited partnership certificate was not the

avoid sanctions in both types of cases is essentially the same.⁴⁶

proximate cause of the plaintiffs' loss of their investment); MALLEN & LEVIT § 73; Bridgman, *Legal Malpractice—A Consideration of the Elements of a Strong Plaintiff's Case*, 30 S. CAROLINA L. REV. 213, 234-36 (1979). These elements are not required in a disciplinary action. Disciplinary sanctions may be imposed regardless of any client injury or damages. See e.g., *Kentucky Bar Ass'n v. Roberts*, 579 S.W.2d 107 (Ky. 1979) (attorney suspended for 90 days because of improper conflict of interest, even though he voluntarily withdrew from the suit creating the conflict after the disciplinary action was filed). A settlement with a client and reimbursement of all losses will likewise not prevent discipline from being imposed. See, e.g., *Caldwell v. State Bar*, 13 Cal. 3d 488, 531 P.2d 785, 119 Cal. Rptr. 217 (1975); *Iowa State Bar Ass'n v. Kraschel*, 260 Iowa 187, 148 N.W.2d 621 (1967); *State v. Hatcher*, 452 P.2d 150 (Okla. 1969); *State v. Hartman*, 54 Wis. 2d 47, 194 N.W.2d 653 (1972). Similarly, defenses to malpractice actions not related to the lawyer's conduct, such as contributory negligence, will not bar a disciplinary action. See MALLEN & LEVIT § 172; Norby, *The Burdened Privilege: Defending Lawyers In Disciplinary Proceedings*, 30 S. CAROLINA L. REV. 363, 417-51 (1979). These differences are justified on the grounds that disciplinary actions are *sui juris* and are designed to protect the profession and the administration of justice. See *id.* at 377-82. Malpractice actions however, have as their principal aim protection of the client.

(3) The burden of proof in a malpractice action is the preponderance of the evidence test generally applicable to civil suits. See MALLEN & LEVIT §§ 416-17. On the other hand most jurisdictions require clear and convincing evidence of the charges before imposing sanctions in a disciplinary hearing. See, e.g., *Collins Securities Corp. v. SEC*, 562 F.2d 820 (D.C. Cir. 1977); ABA JOINT COMMITTEE ON PROFESSIONAL DISCIPLINE, STANDARDS FOR LAWYER DISCIPLINE AND DISABILITY PROCEEDINGS § 8.40 (1979); Norby, *supra* this note, at 391-92. In a malpractice action however, expert testimony is generally required to establish the failure of a lawyer to act in a competent manner, unless the negligence is so obvious that it is within the common knowledge of a layman. Compare, e.g., *Schmidt v. Hinshaw, Culbertson, Moelmann, Hoban & Fuller*, 75 Ill. App. 3d 516, 394 N.E.2d 559 (1979) with *Hill v. Okay Constr. Co.*, 252 N.W.2d 107 (Minn. 1977). See generally 17 A.L.R.3d 1442 (1968). There is no similar requirement in a disciplinary action, where the disciplinary commission and the state's supreme court, rather than a jury, are the fact finders. See also note 49, *infra*.

⁴⁶ There is as yet no uniformly accepted definition of legal competence. See MALLEN & LEVIT § 112. As far as malpractice is concerned, the standard of competence established in section 299A of the Restatement (Second) of Torts (1965) is gaining widespread acceptance:

Unless he represents that he has greater or less skill or knowledge, one who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities.

This standard applies to all professional persons. Malpractice cases involving doctors are, therefore, applicable to malpractice suits against lawyers. See, e.g.,

The current process of mutual interdependence and reinforcement will undoubtedly lead to a gradual melding of these two lines of cases. One significant distinction, however, will probably not disappear. Courts have consistently refused to impose disciplinary sanctions for a single inadvertent act of incompetence on the grounds that the primary purpose of disciplinary actions is to punish only willful or intentional behavior that falls below a minimum level.⁴⁷ Nevertheless, a client may have a cause of ac-

Horne v. Peckham, 97 Cal. App. 3d 404, 158 Cal. Rptr. 714 (3d Dist. 1979); Berman v. Rubin, 138 Ga. App. 849, 227 S.E.2d 802 (1976); Haughey, *Lawyers Malpractice: A Comparative Appraisal*, 48 NOTRE DAME LAW. 888 (1973).

The definition of competency in DR 6-101, quoted in note 38, *supra*, is somewhat less explicit. Rule 1.1 of the Proposed Model Rules is more helpful and more in line with the Restatement. It states that:

A lawyer shall undertake representation only in matters in which the lawyer can act with adequate competence. Adequate competence includes the specific legal knowledge, skill, efficiency, thoroughness, and preparation employed in acceptable practice by lawyers undertaking similar matters.

This incorporates DR 6-101(A)(1) and (2). The duty of promptness in DR 6-101(a)(3) is included as a separate rule. *See* PROPOSED MODEL RULE 1.2. None of these formulations is in fact a concrete definition of competence. Rather, they essentially establish a minimum standard of conduct, which if met or exceeded in a particular case, results in protection against any kind of sanctions. *See, e.g.*, Hutchinson v. Gertsch, 97 Cal. App. 3d 605, 159 Cal. Rptr. 40 (2d Dist. 1979) (court found that an attorney had evidenced more than the minimum skill required), *cf.* ABA INFORMAL OPINION 1442 (1979) (DR 6-101 does not define competency but together with the cases does provide guidelines). The facts of each case determine whether the minimum standard has been met.

⁴⁷ Proof of conduct indicative of gross or wilful negligence or evidence of a course of conduct involving incompetence is generally recognized as a prerequisite for any type of public discipline. "Disciplinary Rules 6-101(a)(2) or (3) become applicable if the lawyer's conduct in furnishing his opinion involves indifference and a consistent failure to carry out the obligations he assumed to his client or a conscious disregard for the responsibility owed to his client." ABA FORMAL OPINION 335 n.1 (1974). In defining neglect under DR 6-101(3), ABA INFORMAL OPINION 1273 (1973) states:

Neglect involves indifference and a consistent failure to carry out the obligations which the lawyer has assumed to his client or a conscious disregard for the responsibility owed to the client. The concept of ordinary negligence is different. Neglect cannot be found if the acts or omissions complained of were inadvertent or the result of an error of judgment made in good faith.

The comment to Proposed Rule 1.1 states:

A lawyer's failure to act competently in a particular matter can be a matter of disciplinary inquiry even if the failure is an apparently

tion for malpractice even if discipline is inappropriate under the circumstances. On the other hand, if the incompetence is sufficient to justify disciplinary action a technical defense, such as the statute of limitations applicable to a malpractice claim, would not bar a disciplinary action based on the same set of facts.⁴⁸

isolated incident. Competence in practice is a continuous undertaking to be assessed on the basis of specific instances. At the same time, the fact that the lawyer has failed to act with sufficient care and competence on a particular occasion ordinarily may not warrant disciplinary sanction except possibly a warning.

Similarly, Rule 6-101 of the CALIFORNIA RULES OF PROFESSIONAL CONDUCT, *supra* note 3, requires willful or habitual conduct for discipline based on incompetence. This rule is consistent with prior California case law. *See* *Demain v. State Bar*, 3 Cal. 3d 381, 375 P.2d 652, 90 Cal. Rptr. 420 (1970); *Outcault & Peterson, Lawyer Discipline and Professional Standards in California: Progress and Problems*, 24 HASTINGS L.J. 675, 692-96 (1973).

Courts will, however, impose disciplinary sanctions for conduct in connection with a single client which is characterized as willful, reckless or indifferent. Most of these cases have involved delays in handling cases. *See, e.g., Selznick v. State Bar*, 16 Cal. 3d 704, 547 P.2d 1388, 129 Cal. Rptr. 108 (1976) (3 year suspension for failure to file a criminal appeal after collection of the fee and repeated promises to do so); *In re Greene*, 276 Or. 1117, 557 P.2d 644 (1976) (negligence in handling a probate matter). *See also State ex rel. Neb. State Bar Ass'n v. Holscher*, 193 Neb. 729, 230 N.W.2d 75 (1975) (single act of negligence, a failure to locate a statute, characterized as reckless, led to receiving improper fees in several cases).

Peer review and remedial action are currently being advocated as methods of coping with lawyer behavior that is not serious enough to justify disciplinary sanctions. *See Smith, Peer Review: Its Time Has Come*, 66 A.B.A.J. 451 (1980); *In re Greene*, 276 Or. 1117, 557 P.2d 644 (1977) (practicing lawyer required to take a law school course in Professional Responsibility and receive a grade of at least a B because of failure to discover an obvious conflict of interest).

⁴⁸ *See* the authorities cited in note 45 *supra*. It is well settled, for example, that acquittal of criminal charges is no bar to a disciplinary action based on the same set of facts. *See, e.g., In re Echeles*, 430 F.2d 347 (7th Cir. 1970); *Kee Wong v. State Bar*, 15 Cal. App. 3d 528, 542 P.2d 642, 125 Cal. Rptr. 482 (1975); *Annot.* 76 A.L.R.3d 1028 (1977). A more difficult issue concerns the preclusive effect against a lawyer of a finding in a non-disciplinary action. If the other action is based on malpractice or is one in which only a preponderance of the evidence is required, then a lawyer should not be collaterally estopped in a disciplinary action from contesting the findings and conclusions. *See, e.g., In re Gygi*, 273 Or. 463, 541 P.2d 1392 (1975) (deals with the effect in a disciplinary action of findings in a private Rule 10b-5 action); *Committee on Legal Ethics v. Mullins*, 226 S.E.2d 427 (W. Va. 1976) (malpractice findings admissible but not conclusive). Where the prior suit results in a criminal convic-

Whatever the final relationship between disciplinary and civil claims comes to be, it will no doubt retain at least one unifying theme—a lawyer must render legal services competently. This theme is particularly important for practitioners serving small business clients. Pragmatic pressures often result in practices that are close to or exceed the attorney's areas of expertise. Compliance with the applicable standards must begin with an analysis of what "competence" entails. Only then can a conscientious practitioner adjust his or her conduct to conform to both the disciplinary and the malpractice standard of competence.

II. COMPONENTS OF THE CONCEPT OF COMPETENCE

An analysis of the existing malpractice and disciplinary cases

tion, however, an attorney is not allowed to challenge the facts in a subsequent disciplinary action. *See e.g.*, *In re Lytton*, 48 Ill. 2d 390, 270 N.E.2d 32 (1971). (plea of *nolo contendere* to a § 17(a) federal securities law violation treated as conclusive evidence of the underlying facts in a subsequent disciplinary action); Annot., 18 A.L.R.3d 1408 (1968). The only issue in the disciplinary hearing is the nature and extent of the discipline to be imposed. ABA JOINT COMMITTEE ON PROFESSIONAL DISCIPLINE, STANDARDS FOR LAWYER DISCIPLINE AND DISABILITY PROCEEDINGS § 9.4 (1979). The difference is attributable to the higher standard of proof in criminal cases. *See Florida Bar v. Craig*, 238 So. 2d 78 (Fla. 1970).

Similar preclusive effect is given to adverse findings of fact in disciplinary proceedings brought in another jurisdiction. *See, e.g.*, *In re Cook*, 67 Ill. 2d 26, 364 N.E.2d 86 (1977); ABA JOINT COMMITTEE ON PROFESSIONAL DISCIPLINE STANDARDS FOR LAWYER DISCIPLINE AND DISABILITY PROCEEDINGS § 10.2 (1979); Annot., 81 A.L.R. 3d 1281 (1977). Whether disciplinary sanctions against a lawyer under Rule 2(e) of the SEC's Rules of Practice, 20 C.F.R. § 201.2(e) (1979), discussed at note 20 and accompanying text *supra*, will be given similar conclusive effect is unknown. The reciprocal discipline rule is generally limited to proceedings in another jurisdiction; and the issue would be whether the SEC constituted "another jurisdiction." No cases on this issue could be located. Under Rule 2(e), however, authority to practice before the SEC will automatically be suspended upon suspension, disbarment, or conviction of a felony or a crime involving moral turpitude. 17 C.F.R. § 201.2(e)(2) (1979).

An additional question in this area concerns the effect of disciplinary findings on pending or subsequent civil actions against the attorney involving the same facts. There is little authority on this point. In the case of *In re Estate of Gould*, 547 S.W.2d 863 (Mo. App. 1977), a lawyer who had been disbarred for his handling of an estate was held collaterally estopped to relitigate the facts or findings in a subsequent suit to remove him as executor of the estate and to deny him any attorney's fees. *But see Kuehn v. Garcia*, 608 F.2d 1143 (8th Cir. 1979); *Rachel v. Hill*, 435 F.2d 59 (5th Cir. 1970), *cert. denied*, 403 U.S. 904 (1971).

indicates that there are five overlapping but nevertheless fairly distinct sets of legal duties that in combination make up the concept of competency: (1) proper preparation with respect to both the applicable law and facts; (2) reasonable skill and judgment in applying the relevant law to the facts; (3) promptness in handling legal matters undertaken; (4) full disclosure to the client of the attorney's informed judgment; and (5) the obligation to render independent, objective advice to the client. Each of these categories is separately examined below.

A. *Proper Preparation*

1. Knowledge of the Applicable Law

All lawyers are presumed to have a minimum level of knowledge. This minimum consists of at least the statutes and case law of the state, local rules of practice, elementary principles of law commonly known by attorneys, and additional legal principles that can be discovered through the use of standard research techniques.⁴⁹ Therefore, courts have not hesitated to reject defenses based on ignorance of the law made by lawyers. In one recent case,⁵⁰ for example, a county attorney claimed that he had failed, because of the pressure of other legal work, to learn of a recently passed statute that made his handling of tax sales improper. In publicly reprimanding the attorney, the Supreme Court of Nebraska stated that ignorance of the statute was "conduct so carelessly and recklessly negligent that we would have to find respondent did it knowingly. Otherwise we might as well forget the Code of Professional Responsibility."⁵¹

⁴⁹ See *Goodman & Mitchell v. Walker*, 30 Ala. 482, 496, 68 Amer. Dec. 134 (1857); *Smith v. Lewis*, 13 Cal. 3d 349, 358-59, 530 P.2d 589, 595, 118 Cal. Rptr. 621, 627 (1975); *Citizens' Loan, Fund & Savings Ass'n v. Friedley*, 123 Ind. 143, 146, 23 N.E. 1975 (1889). *McCullough v. Sullivan*, 102 N.J.L. 381, 132 A. 102 (1926); *George v. Caton*, 600 P.2d 822 (N.M. Ct. App. 1979); *In re Woods*, 158 Tenn. 383, 13 S.W.2d 800 (1929); *Clinton v. Miller*, 124 Mont. 463, 226 P.2d 487 (1951); *Ward v. Arnold*, 52 Wash.2d 581, 328 P.2d 164 (1958).

⁵⁰ *State ex rel. Neb. State Bar Ass'n v. Holscher*, 193 Neb. 729, 230 N.W.2d 75 (1975).

⁵¹ *Id.* at 736, 230 N.W.2d at 79. At a later point in the opinion, the Court stated "[i]t is inexcusable for an attorney to attempt any legal procedure without ascertaining to the law governing the procedure." *Id.* at 736, 230 N.W.2d at 80. Courts have applied the same rationale to cases involving small business clients. In *Moser v. Western Harness Racing Ass'n*, 89 Cal. App. 2d 1, 200 P.2d 7 (2d Dist. 1949), for example, a lawyer sued a closely held corporation for

The presumed amount of knowledge encompassed under this minimum standard increases as the number of statutes, case law and settled legal principles increases.⁵² A point of law that several years ago may have been viewed as being unsettled or otherwise outside the scope of general knowledge of all lawyers may well be considered today as being included within this general knowledge standard. For example, in *Lucas v. Hamn*,⁵³ the Supreme Court of California held in 1961 that a lawyer was not liable in a malpractice action for drafting a will that violated the rule against perpetuities. The Court seemed to base its opinion on the grounds that no lawyer could be expected to understand the intricacies of the perpetuities rule. In a 1975 case, however, the California Court of Appeals stated:

There is reason to doubt that the ultimate conclusion of *Lucas v. Hamn* is valid in today's state of the art. Draftsmanship to avoid the rule against perpetuities seems no longer esoteric.⁵⁴

Moreover, the extent of knowledge falling within this general standard is probably much broader than most lawyers suspect. Knowledge of all the basic legal principles applicable to the legal problem in question is required. This issue has arisen most frequently in malpractice actions against general practitioners for inadequate knowledge of tax law. In rejecting a claim that requiring an attorney to know the tax consequences of powers of appointment would force every attorney to become a tax specialist or to refer all estate planning problems to an estate tax specialist, the California Court of Appeals stated in a 1976 decision:

We merely hold that the potential tax problems of general powers of appointment in inter vivos or testamentary marital deduction trusts were within the ambit of a reasonably competent and dili-

attorney's fees. The court denied recovery because in its judgment the attorney had failed to discover a well settled point of law regarding the revocation of stock subscription agreements and as a consequence had given the client an incorrect legal opinion. *Id.*

⁵² Commenting on the changing role of a lawyer in our increasingly complex society, The California Supreme Court recently stated "As more individuals come to depend upon him, his responsibility must broaden and deepen." *Neel v. Magana, Olney, Levy, Cathcart & Gelfand*, 6 Cal. 3d 176, 194, 491 P.2d 421, 432-33, 98 Cal. Rptr. 837, 848-49 (1971).

⁵³ 56 Cal. 2d 583, 364 P.2d 681, 15 Cal. Rptr. 821, *cert. denied*, 368 U.S. 987 (1961).

⁵⁴ *Wright v. Williams*, 47 Cal. App. 3d 802, 809 n.2, 121 Cal. Rptr. 194, 199 n.2 (2d Dist. 1975).

gent practitioner from 1961 to present.⁵⁵

In short, every practitioner is presumed to know basic tax principles.⁵⁶

If a lawyer does not have the requisite minimum knowledge, he or she must undertake research to determine the applicable legal principles and will be held to know the law that proper research would have located.⁵⁷ At the very least, the supplements to relevant state or federal statutes and regulations as well as advance sheets must be reviewed.⁵⁸ In an opinion publicly reprimanding a lawyer for, among several improprieties, an incorrect legal opinion resulting from his failure to read the cases in the annotation following a statute, the Supreme Court of Washington characterized the attorney's action as grossly negligent.⁵⁹ The court stated:

⁵⁵ *Bucquet v. Livingston*, 57 Cal. App. 3d 914, 925, 129 Cal. Rptr. 514, 521 (2d Dist. 1976).

⁵⁶ *See Horne v. Peckham*, 97 Cal. App. 3d 404, 409-14, 158 Cal. Rptr. 714, 717-20 (3d Dist. 1979) (malpractice verdict of \$64,983.31 against general practitioner upheld in a case involving a transfer of a patent to a Clifford trust). *See also Legal Ethics Forum-Professional Competence: How to Measure It, What To Do About It*, 63 A.B.A.J. 1645 (1977) for an interesting discussion on this point.

⁵⁷ *See, e.g., Smith v. Lewis*, 13 Cal. 3d 349, 530 P.2d 589, 118 Cal. Rptr. 621 (1975) (\$100,000 judgment against lawyer who failed to conduct any research upheld); *Ramp v. St. Paul Fire and Marine Ins. Co.*, 263 La. 774, 269 So. 2d 239 (1972); *Humboldt Bldg. Ass'n v. Duker's Ex's*, 111 Ky. 759, 64 S.W. 671 (1901).

⁵⁸ *See, e.g., In re A.B.*, 1 Tuck. 247 (N.Y. Surr. Ct. 1866) (failure to locate a recently enacted statute). *Boss-Harrison Hotel Co. v. Barnard*, 266 N.E.2d 810, 811 (Ind. Ct. App. 1971) (court chastised a lawyer for not citing in his original brief an opinion published two months earlier, stating that "good appellate advocacy demands the regular reading of the Advance Sheets.") *Cf. Bameroft v. Indemnity Ins. Co.*, 203 F. Supp. 49 (W.D. La. 1962) (CPA held liable in malpractice action for failing to find a newly enacted tax statute that made taxable a transaction he had advised was non-taxable).

Courts have also dismissed summarily defenses based on ignorance of published ethical rules. *See In re Eisenberg*, 75 N.J. 454, 456-57 n.1, 383 A.2d 426, 427 n.1 ("Although this astonishing lack of familiarity with the rules is sometimes characterized as a 'defense,' ignorance of our ethical rules and case law cannot be permitted to diminish responsibility for conduct in violation of these rules); *State v. Hollstein*, 202 Neb. 40, 274 N.W. 2d 508 (1970) (defense based in part on lack of knowledge of advisory ethics opinion that was circulated to all members of the bar rejected); *In re Bartlett*, 283 Or. 487, 584 P.2d 296 (1978).

⁵⁹ *In re Boland*, 140 Wash. 148, 249 P. 399 (1926).

Not always can an attorney be expected to know the law upon a given subject, but when he is employed to ascertain it, the greater his ignorance the greater his duty to inform himself.⁶⁰

In addition, an attorney must consult readily available standard treatises in the relevant areas.⁶¹

There are as yet no cases dealing with a situation where one of the standard resources is not available locally. For example, a lawyer living in a small, rural community may not have access to one of the recognized treatises on corporate or partnership tax. Is such a lawyer subject to a lower level of knowledge than a big city counterpart who has access to these books in his or her law office or in a local public law library? Under a well recognized rule in malpractice cases, professionals are held to the standard of skill and knowledge normally possessed by members of the profession in similar communities; and⁶² there is respectable authority from medical malpractice cases that the requisite standard of competence varies with the availability and quality of local medical facilities.⁶³ Since lawbooks are for attorneys what hospitals and medical equipment are for doctors, and courts

⁶⁰ *Id.* at 159, 249 P. at 402 (1926).

⁶¹ The cases have not discussed in any great detail what secondary authorities are considered "readily available." In *Smith v. Lewis*, 13 Cal. 3d 349, 356, 530 P.2d 589, 593, 118 Cal. Rptr. 621, 625 (1975), the court listed as "authoritative reference works which attorneys routinely consult for a brief and reliable exposition of the law" to discover the status of vested pension rights in California: A.L.R., American Jurisprudence 2d, Corpus Juris Secundum, California Jurisprudence 2d, California Family Lawyer, and Witken, California Family Law. In *Wright v. Williams*, 47 Cal. App. 3d 802, 121 Cal. Rptr. 194 (2d Dist. 1975), the court cited a treatise on will drafting and another on real property law published by the Continuing Education Division of the California Bar Association. In *Moser v. Western Harness Racing Ass'n*, 89 Cal. App. 2d 1, 200 P.2d 7, 12 (2d Dist. 1949), discussed at note 51 *supra*, the Court mentioned California Jurisprudence, American Jurisprudence, Corpus Juris Secundum and several well known standard corporate treatises as "readily available" sources for determining the established point of corporate law overlooked by the attorney. When federal or "national" law issues such as federal tax, securities, bankruptcy and patent law are involved, then the current recognized treatises in those fields should be consulted. See *Horne v. Peckham*, 97 Cal. App. 3d 404, 158 Cal. Rptr. 714 (3d Dist. 1979) (tax case). Interestingly, none of these cases mention law reviews as being readily available sources.

⁶² See, e.g., *Robbins v. Footer*, 553 F.2d 173 (D.C. Cir. 1977); *Gambill v. Stroud*, 531 S.W. 2d 945 (Ark. 1976) RESTATEMENT (SECOND) OF TORTS § 299A, Comment (g) (1965).

⁶³ See RESTATEMENT (SECOND) OF TORTS § 299A (1965); MALLEN & LEVIT §§ 112, 115.

have generally applied other principles developed in medical malpractice cases to similar cases involving lawyers,⁶⁴ the medical malpractice rule would seem to be properly applicable. A small town or rural practitioner, however, could not rely on this concept to shield himself against all liability based on ignorance of the law. For example, no practitioner could claim immunity from malpractice and disciplinary claims on the grounds that he had no lawbooks and none were available in his community. Wherever they practice, lawyers are presumed to know the state statutes, case law, local rules of practice, and well settled legal principles.⁶⁵ Of course, where federal law is involved, for example federal tax, securities, or bankruptcy, then the practitioner, regardless of location, is presumed to know or to have access to the applicable federal statutes, regulations, case law and basic legal principles as set forth in standard treatises in the particular field.⁶⁶

A related question concerns the required level of knowledge a lawyer must have of the law of a foreign state. The modern cases consistently hold that if a lawyer undertakes to advise a client with respect to the laws of another state, he or she will be held to the same standard of knowledge required of a lawyer in the second state.⁶⁷ For example, if an attorney admitted to practice

⁶⁴ See, e.g., *Berman v. Rubin*, 138 Ga. App. 849, 227 S.E.2d 802 (1976); *Horne v. Peckham*, 97 Cal. App. 3d 404, 158 Cal. Rptr. 714 (3d Dist. 1979). See generally Haughey, *Lawyers Malpractice; A Comparative Analysis*, 48 NOTRE DAME LAW. 888 (1973).

⁶⁵ See notes 49-56 and accompanying text *supra*. See also *Hansen v. Wightman*, 14 Wash. App. 78, 538 P.2d 1238 (1975) (the basic standard of care and skill by attorneys is the same throughout the state); MALLEN & LEVIT § 115.

⁶⁶ See *Horne v. Peckham*, 97 Cal. App.3d 404, 158 Cal. Rptr. 714, 717-20 (3d Dist. 1979) and note 58 *supra*. In effect, the local circumstances limitation applies primarily to legal materials that are generally only available to a specialist or in a large metropolitan law library. Private ruling letters published by the Internal Revenue Service would be one example. Recent Revenue Rulings not included in the standard tax treatises would also probably qualify.

⁶⁷ The leading modern case on this issue is *Degan v. Steinbrink*, 202 App. Div. 477, 195 N.Y.S. 810 (1922) where a lawyer failed to file a mortgage properly in New Jersey. The court stated:

When a lawyer undertakes to prepare papers to be filed in a state foreign to his place of practice, it is his duty, if he has not knowledge of the statutes, to inform himself, for, like any artisan, by understanding the work, he represents that he is capable of performing it in a skillful manner. Not to do so and to prepare documents that have no legal potency, by reason of their lack of compli-

in state *A* writes an opinion for a small business client discussing the law in state *B*, he or she would be liable for any legal errors

ance with simple statutory requirements is such a negligent discharge of his duty to his client as should render him liable for loss sustained by reason of such negligence. . . .

It would be a very dangerous precedent to adopt that in this state, where, by reason of its being the financial center of the Union, members of the bar are called upon to advise as to large loans, and to draft instruments securing such loans, that must be filed or recorded in other states, attorneys could escape liability for unskilled and negligent work which rendered the securities worthless, and could shield themselves behind the plea:

"I am a New York lawyer. I am not presumed to know the law of any other state."

If the attorney is not competent to skillfully and properly perform the work, he should not undertake the service.

Id. at 481, 195 N.Y.S. at 814. See also *Rekeweg v. Federal Mut. Ins. Co.*, 27 F.R.D. 431 (N.D. Ind. 1961), *aff'd*, 324 F.2d 150 (7th Cir. 1963), *cert. denied*, 376 U.S. 943 (1964); *John v. Bernstein*, 279 A.2d 529 (Me. 1971); *In re Roel*, 3 N.Y.2d 224, 165 N.Y.S.2d 31, 144 N.E.2d 24, *appeal dismissed sub nom. Roel v. New York County Lawyers Ass'n*, 355 U.S. 604 (1958). *Contra Fenaille & Despeaux v. Coudert*, 44 N.J.L. 286 (Sup. Ct. 1882). See generally Albenda, Gillen, Burlingame, Landau, Watts, Richardson & McCann, *Legal Opinions Given in Corporate Transactions*, 33 BUS. LAW. 2389, 2405-11 (1978); Martinsdale, *Attorney's Liability in Non-client and Foreign Law Situations*, 14 CLEV. MAR. L. REV. 44 (1965).

Lawyers frequently associate counsel in another state to advise the lawyer and the client on the local law. Unless the client agrees that the original attorney will have no further responsibility in the matter, both attorneys will be liable to the client as joint venturers. See *Tormo v. Yormark*, 398 F. Supp. 1159, 1173 (D.N.J. 1975); *Floro v. Lawton*, 187 Cal. App. 2d 657, 10 Cal. Rptr. 98 (2d Dist. 1960). In effect, the referring lawyer has two separate duties: first, to use due care in selecting the other attorney and second, unless relieved of further responsibility in the case, to properly supervise associated counsel. *Tormo v. Yormak*, 398 F. Supp. 1159 (D.N.J. 1975). In *Tormo*, the court held that the out of state referring attorney had satisfied the duty of proper selection when he checked the name of the other attorney in a recognized legal directory and that it was not necessary to consult references, the grievance commission or local prosecutors. At the time of the referral the other attorney was under indictment for embezzling money from an insurance company.

Another interesting question concerns the possibility of an unauthorized practice of law claim against an out of state lawyer if local counsel is not retained. There is no substantial case authority on this point, but it would seem that any sanction should be based solely on the quality of the legal services rendered. See Martinsdale, *supra* this note, at 57-63. Prosecuting an out of state lawyer for filing documents or performing other routine legal tasks in another state seems pointless. Of course, if the matter is not routine, the wise attorney will always associate competent local counsel.

in the opinion to the same extent as would a lawyer admitted to practice in state *B*.

The ultimate question is whether in addition to being held to this common standard, lawyers will be held to the knowledge level of a specialist. There is a definite trend toward answering this question affirmatively, at least insofar as certified or *de facto* specialists are concerned. The leading case is *Wright v. Williams*,⁶⁸ decided by the California Court of Appeals in 1975. The court stated:

We thus conclude that a lawyer holding himself out to the public and the profession as specializing in an area of the law must exercise the skill, prudence, and diligence exercised by other specialists of ordinary skill and capacity specializing in the same field.⁶⁹

In other words, a specialist will be judged on the basis of other specialists in the same field and not merely on the standards of a general practitioner.⁷⁰ As one court aptly stated: "a lawyer may not gain business as a specialist and defend mistakes as a

⁶⁸ 47 Cal. App. 3d 802, 121 Cal. Rptr. 194 (2d Dist. 1975).

⁶⁹ *Id.* at 810, 121 Cal. Rptr. at 199.

⁷⁰ See MALLEN & LEVIT § 114. An unresolved issue is whether the appropriate standard should be that of other specialists in the state practicing under similar circumstances or other similar specialists anywhere in the United States. A few courts have applied a nationwide standard in malpractice cases involving medical specialists. See *Robbins v. Footer*, 553 F.2d 123 (D.C. Cir. 1977); *Shilkret v. Annapolis Emergency Hospital Ass'n*, 276 Md. 187, 349 A.2d 245 (1975). Medical specialists, however, are generally certified on the basis of standards set by a national board of certification, whereas the legal specialist certification rules promulgated to date vary from state to state. In addition, not all states have an official certification program.

Nevertheless, a great many lawyers are *de facto* specialists in one or more fields. See, e.g., *Committee on Specialization—Results of Survey on Certification of Specialists*, 44 CAL. ST. B.J. 140 (1969) (two thirds of the lawyers in California limit their practice to one or more fields). See also note 1 *supra*. At the very least a specialist, certified or *de facto*, should be judged by the standard of other similar specialists in the state. In some fields of federal law, for example federal tax and securities law, a national standard may be appropriate. See MALLEN & LEVIT § 115, at 184; *Lathrop v. Rinehart*, *Legal Malpractice and Rule 10(b)(5) Liability: Pitfalls for the Occasional Securities Practitioner*, 5 LOYOLA L.A. L. REV. 429, 465-73 (1972). Local or state issues, however, are invariably involved in these fields. For example, state tax consequences may be quite different from the federal tax consequences for a particular transaction. Similarly, compliance with the state Blue Sky Statute as well as the Federal Securities Acts is necessary in any distribution of securities. If a national standard is used, then it would be necessary to factor these local issue questions into the standard.

layman."⁷¹

A more difficult issue concerns the standard to which a general practitioner will be held when he or she counsels a small business client in an area ordinarily handled by a specialist or otherwise beyond the lawyer's expertise. Although there are several medical malpractice cases which have applied a rule that general practice physicians will be held to the standard of a specialist if such tasks are undertaken,⁷² there are only a few cases involving lawyers on point.⁷³ The most recent is a California Court of Appeal decision involving complex trust, tax and patent law issues.⁷⁴ In the course of the opinion, which sustained a verdict against a general practitioner for malpractice, the court approved the following jury instruction:

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.

⁷¹ *Coberly v. Superior Court*, 231 Cal. App. 2d 685, 689, 42 Cal. Rptr. 64, 67 (2d Dist. 1965). In this connection, Rule 6-101 of the CALIFORNIA RULES OF PROFESSIONAL CONDUCT, *supra* note 3, authorizes discipline for failure to perform on a level with lawyers who "perform but do not specialize in similar services. . ." If this rule is interpreted literally, a specialist in California can be liable in malpractice but not subject to discipline so long as his or her performance meets the standards of a general practitioner. No other state has included similar language in adopting DR-6-101. See ABA COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY CODE OF PROFESSIONAL RESPONSIBILITY BY STATE (1977).

⁷² See, e.g., *Ayers v. Parry*, 192 F.2d 181 (3d Cir. 1951), *cert. denied*, 343 U.S. 980 (1952); *Gambill v. Stroud*, 531 S.W.2d 945 (Ark. 1976); *Crovella v. Cochrane*, 102 So. 2d 307 (Fla. Ct. App. 1958).

⁷³ See, e.g., *Louisiana State Bar Ass'n v. Gremillion*, 320 So. 2d 171 (La. 1975) (ignorance of real estate law no defense to a disciplinary action); *Trimboli v. Kindal*, 226 N.Y. 147, 123 N.E. 205 (1919). See generally *Schnidman & Salzer, The Legal Malpractice Dilemma: Will New Standards of Care Place Professional Liability Insurance Beyond the Reach of the Specialist?*, 9 SW. U.L. REV. 613, 621-25 (1977); *Comment, Specialization: The Resulting Standard of Care and Duty to Consult*, 30 BAYLOR L. REV. 729, 733-38 (1978); *Comment, Attorney Malpractice*, 63 COLUM. L. REV. 1292, 1302-04 (1963).

⁷⁴ *Horne v. Peckham*, 97 Cal. App. 3d 404, 158 Cal. Rptr. 714 (3d Dist. 1979).

A failure to perform any such duty is negligence.⁷⁶

The obligation to associate a specialist in these cases is also included as part of DR 6-101(A)(1), which states:

A lawyer shall not . . . [h]andle a legal matter which he knows or should know that he is not competent to handle, without associating with him a lawyer who is competent to handle it.⁷⁶

The clear implication of this rule is that a lawyer undertaking legal tasks beyond his or her competence will be held to the standard of a competent lawyer in the area and will be subject to discipline if he or she fails to achieve this standard.⁷⁷

This formulation is strengthened in the Proposed Model Rules of Professional Conduct. Proposed Rule 1.1, as published in January, 1980, states that "adequate competence includes the specific legal knowledge . . . employed in acceptable practice by lawyers undertaking similar matters." The standard, according to the comment, "is the skill and knowledge possessed by lawyers who ordinarily handle such matters."⁷⁸

⁷⁶ *Id.* at 414, 158 Cal. Rptr. at 720. One interesting aspect of this case is the fact that the lawyer had obtained some basic information on the main issue, Clifford Trusts, from an accountant and at one point had a conference on the subject with a tax attorney who represented the client's business in connection with a proposed deferred compensation and profit-sharing plan. The court found, however, that the lawyer did not review the specific problem involved in the case with the tax attorney. A judgment in favor of the tax attorney in a cross complaint by the defendant was affirmed.

⁷⁶ ABA CODE DR 6-101(A)(1).

⁷⁷ See *Louisiana State Bar Ass'n v. Gremillion*, 320 So. 2d 171 (La. 1975) (lawyer permanently disbarred for several improprieties, including the issuance of an incorrect title opinion; one of his defenses was ignorance of property law, which the Court rejected, citing DR 6-101(A)(1)). The other side of the coin is the lawyer's duty not to undertake representation if not competent in the area and if unwilling either to become proficient or to associate another lawyer. In at least two cases, contempt citations against lawyers who refused to represent criminal defendants because of their lack of expertise have been reversed. DR 6-101(A)(1) was an important factor in both cases. *Easley v. State*, 334 So. 2d 630, 632 (Fla. Ct. App. 1976) ("Moreover, in accord with the ethical obligations of an attorney, we think it was incumbent upon appellant to communicate his feelings of lack of competence to the defendant. . ."); *State v. Gasen*, 48 Ohio App. 2d 191, 356 N.E.2d 505 (1976). Cf. ABA INFORMAL OPINION 1442 (1979) (obligation of attorney to undertake work in an unfamiliar area when instructed to do so by a superior).

⁷⁸ PROPOSED MODEL RULES, at 8.

The same comment also states:

Where a matter properly should be handled by a specialist . . . , a

2. Factual Investigation

Knowledge of the relevant law is only the first step involved in rendering competent counseling to small business clients. The competent lawyer must also determine all the relevant facts. The scope of the engagement normally defines the outer limits of factual inquiry.⁷⁹

The scope of employment rule is subject to two important exceptions. First, even though a lawyer may be retained to perform only a specific legal task, if the lawyer discovers during the investigation facts which indicate the client has a different or

lawyer ordinarily should accept the matter only if he or she can act with the knowledge and skill possessed by such specialists or can gain the necessary knowledge and skill without undue expense to the client.

Id. Deciding what amount to charge a client for learning the law in a new area presents difficult issues. The fee, of course, must be "reasonable." See EC 2-17 and 2-18; DR 2-106; *In re Rolin*, 19 App. Div. 460, 243 N.Y.S.2d 731 (1963) (three month suspension for overcharging in connection with a business transaction). One court, however, recently denied attorney's fees to appointed counsel in a criminal case for reading and analyzing approximately 25 cases, which the court characterized as basic decisions that should be known by a novice lawyer. *United States v. Tutino*, 419 F. Supp. 246 (S.D.N.Y. 1976). The Court explained:

[T]he bar has long required its members to maintain competence in the areas in which they are to practice, and it seems generally settled that an attorney may not properly charge his client for the time it takes the attorney to obtain general competence in a particular area of the law. [citation omitted]

419 F. Supp. at 251. Even under this rationale, however, once the lawyer has some general familiarity with the area, he could presumably properly charge for the research done on the particular issues involved.

⁷⁹ For example, *Kurtenbach v. TeKippe*, 260 N.W.2d 53 (Iowa 1977) held that a lawyer, retained to form a closely held corporation and paid separately by the corporation for each item of subsequent legal work, was not liable for failure to investigate facts concerning improper stock sales. The court pointed out that the principal shareholder, who had retained the lawyer, had never requested any legal advice on the propriety of the sales, and, without the knowledge of the lawyer, had removed the stock ledger from the attorney's office. Similarly, in *Franke v. Midwestern Oklahoma Development Authority*, 428 F. Supp. 719 (W.D. Okl. 1976), the attorney for an issuer of industrial revenue bonds was held not liable for alleged material misstatements and omissions in the prospectus on the grounds that the alleged improprieties were outside the scope of the lawyer's duties with respect to the bonds. Furthermore, everything in the attorney's legal opinion was factually and legally correct.

more serious legal problem, failure to inform the client of these additional facts would result in sanctions.⁸⁰

Second, while a lawyer can properly limit the scope of the engagement with the consent of the client,⁸¹ in the absence of any limitation, a court will construe the scope broadly and resolve all doubts in favor of the client. For example, in *Gleason v. Title Guarantee Co.*,⁸² a lawyer had been retained to certify the title to real estate. In a subsequent malpractice action based on liens against the property that were not disclosed in the title certificate, one of the defenses by the lawyer was that in accordance with local custom he had not checked the title records. Instead, he relied on oral statements from an agent of a title abstract company that there were no liens. Although conceding that the attorney would not be liable if the client had been fully informed of the facts, the court held that this was not the case, and that the scope of the engagement was not limited by the

⁸⁰ For example, if the lawyer in *Kurtenbach v. TeKippe*, 260 N.W.2d 53 (Iowa 1977), discussed *supra* note 79, had discovered that the principal shareholder had taken the stock transfer book, or that the principal shareholder was selling the stock, then he would have had a legal duty to conduct an investigation. If he discovered that the stock sales were illegal, then he would have had a duty to inform the client of the legal consequences of such action. See *Owen v. Neely*, 471 S.W.2d 705 (Ky. 1971); *Daugherty v. Runner*, 581 S.W.2d 12, 17 (Ky. Ct. App. 1979). Cf. *1136 Tenants' Corp. v. Max Rothenberg & Co.*, 36 App. Div. 3d 804, 319 N.Y.S.2d 1007 (1971), *aff'd mem.* 30 N.Y.S.2d 585, 281 N.E.2d 846, 330 N.Y.2d 800 (1972) where an accounting firm, paid \$600 per year to post the books of a company and to issue monthly unaudited financial reports, was held liable for \$237,278 because of failure to report to the board of the client facts relating to missing invoices of \$14,000 and other irregularities discovered during the course of voluntary spot audit procedures for which no fee was received.

⁸¹ See PROPOSED MODEL RULES 1.5(c). A lawyer, however, cannot limit his or her liability for malpractice committed within the scope of the engagement. DR 6-102(A). See also *Registered Country Homebuilders, Inc. v. Stebbins*, 14 Misc. 2d 821, 179 N.Y.S.2d 602 (Sup. Ct. 1958) (in the absence of a contrary or limiting agreement with the client, a complete title search is required).

If the engagement is limited, then the attorney is protected against liability if the assigned tasks are performed competently. See *Woody v. Mudd*, 258 Md. 234, 265 A.2d 458 (1970) (divorce attorney requested to check for current mortgages against property held not liable for failure to discover that wife had only a dower interest rather than a co-ownership interest in the property). *Franke v. Midwestern Okla. Devel. Authority*, 428 F. Supp. 719 (W.D. Okl. 1976), discussed in note 79 *supra*.

⁸² 300 F.2d 813 (5th Cir. 1962).

local custom.⁸³ By analogy, a lawyer whose opinion that certain securities are exempt from registration contains materially incorrect factual data obtained from the client could not expect to defend successfully a malpractice or disciplinary action on the grounds that other attorneys in the area customarily take at face value all information conveyed by business clients.⁸⁴

The extent of the factual investigation required varies with each case, depending on the nature of the transaction and the lawyer's familiarity with the client and the client's business. Because of the full disclosure obligations under the securities laws, a lawyer representing a client with respect to an issue or distribution of securities has a greater duty of inquiry and verification than is required in most other situations.⁸⁵ As a general rule, a

⁸³ In the course of the opinion, the court stated:

While custom provides an important indication of what constitutes reasonable care and what is negligent, it is not dispositive of the question at issue. All customs are not good customs, and lawyers have no prescriptive right to make knowingly false statements in the name of custom. "No degree of antiquity can give sanction to a usage bad in itself." We can sympathize with the defendant in the fact that he is to be heavily penalized for following the custom while others, perhaps even those who established the custom, may escape adverse consequences. Nevertheless, the custom was improper, and its existence cannot alter Gleason's responsibility to one who has relied on his certification.

Gleason v. Title Guarantee Co., 300 F.2d 813, 814 (5th Cir. 1962). Custom is relevant, however, in determining whether a point of law is recognized as being settled or subject to honest differences of opinion. *See, e.g.*, Smith v. St. Paul Fire & Marine Ins. Co., 366 F. Supp. 1283 (M.D. La. 1973), *aff'd per curiam*, 500 F.2d 1131 (5th Cir. 1974); Hodges v. Carter, 239 N.C. 517, 80 S.E.2d 144 (1954).

⁸⁴ *See, e.g.*, United States v. Brookshire, 514 F.2d 786, 789 (10th Cir. 1975) (custom does not excuse criminal conduct); SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); SEC v. Frank, 388 F.2d 486 (2d Cir. 1968); Collins v. Fitzwater, 277 Or. 401, 460 P.2d 1074 (1977). *See also* ABA FORMAL OPINION 335 (1974). *But see* Milliner v. Elmer Fox and Co., 529 P.2d 806, 808 (Utah 1974).

⁸⁵ For a comprehensive statement of the preparation a lawyer must undertake before issuing an opinion on unregistered securities, *see* ABA FORMAL OPINION 335 (1974). Although the Opinion states it is limited to securities issues, the guidelines discussed clearly apply to other situations. *See generally* Albenda, Gillen, Burlingame, Landau, Watts, Richardson & McCann, *Legal Opinions Given in Corporate Transactions*, 33 BUS. LAW. 2389 (1978); Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371; Fuld, *Lawyers' Standards and Responsibilities in Rendering Opinions*, 33 BUS. LAW. 1295 (1978); Fuld, *Legal Opinions in Business Transactions—An Attempt to Bring Some Order Out of Some Chaos*, 28 BUS. LAW. 915 (1973); Small, *An*

lawyer representing a long-time financially stable business client that has in the past provided the lawyer with accurate facts will have to make less factual verification than in other, less secure situations. Greater factual inquiry is necessary, for example, when a new business client is involved, the client's financial position is precarious, the client has in the past intentionally or unintentionally withheld relevant facts, the facts given are inconsistent, or for any other reason the lawyer suspects he does not have all the relevant facts.⁸⁶

Regardless of the nature of the transaction, the lawyer has the burden in the first instance of making a proper inquiry to determine the relevant facts. A lawyer cannot escape sanctions on the grounds that the client failed to disclose certain facts if the lawyer never asked the client for the facts or otherwise failed to investigate the facts.⁸⁷ As one court has stated, "If the attorney should have inquired concerning the relevant facts and did not, the client cannot be said to have been negligent in failing to disclose said facts."⁸⁸ On the other hand, if the lawyer conducts a proper factual inquiry, then he or she will be protected against sanctions in circumstances where the client fails to provide accu-

Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?, 61 CALIF. L. REV. 1189 (1973).

⁸⁶ See ABA FORMAL OPINION 335. Compare *Fisk v. Newsum*, 9 Wash. App. 650, 513 P.2d 1035 (1973) (attorney handling a stock redemption held not liable for failure to verify a financial statement prepared by a CPA firm and certified by the President to be accurate) with *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968) (liability imposed for improper factual investigation in connection with a public offering).

⁸⁷ In many situations the facts must be obtained from sources other than the client. An attorney obviously has an obligation to check these sources. See, e.g., *Gleason v. Title Guarantee Co.*, 300 F.2d 813 (1962) and *Wlodarek v. Thrift*, 13 A.2d 774 (1940), both of which involved a lawyer's failure to search the title records. See also *In re Greene*, 276 Or. 1117, 557 P.2d 644 (1977) (attorney handling an estate reprimanded in part for failing to determine if assets other than real property sold in a questionable transaction were available to pay back taxes).

Sometimes documents containing important facts are supplied by the client. A lawyer is held to know the facts contained in the documents and such other facts as would have been found if a proper follow-up investigation had been made. See, e.g., *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968); *Dillard Smith Constr. Co. v. Greene*, 337 So. 2d 841 (Fla. Ct. App. 1976); *Trimboli v. Kindal*, 226 N.Y. 147, 123 N.E. 205 (1919); *Ramp v. St. Paul Fire & Marine Ins. Co.*, 263 La. 774, 269 So. 2d 239 (1972).

⁸⁸ *Hansen v. Wightman*, 14 Wash. App. 78, 90, 537 P.2d 1238, 1245 (1975).

rate or complete information.⁸⁹

A lawyer must refuse to render any legal advice on a matter until he or she is confident that all the relevant facts have been determined. In making the investigation, the lawyer can rely on official documents and records supplied by a business client, assuming that there is nothing inconsistent, incomplete or otherwise suspicious about these documents, and does not have an obligation to verify every fact in them.⁹⁰ ABA Formal Opinion 335, which outlines lawyers' ethical responsibilities when rendering opinions on the exempt status of securities, states that a lawyer "does not have the responsibility to 'audit' the affairs of his client or to assume, without reasonable cause, that the client's statement of the facts cannot be relied upon."⁹¹

B. Skill

Skill is the second basic component of competence. Skill involves the interpretive and judgment powers of a lawyer. Legal skill is the ability of a lawyer to use knowledge of law and facts effectively to accomplish a particular task.

Although courts often lump together knowledge and skill, adequate preparation or knowledge is actually a prerequisite to the use of legal skill. A lawyer cannot make an informed decision or an intelligent assessment of a legal problem without adequate research into the relevant facts and law. A recent Florida opinion,⁹² for example, held a lawyer civilly liable for failing to read a construction contract prior to advising a subcontractor client on the proper method of seeking final payment. The court stated:

⁸⁹ See *Vredenburgh v. Jones*, 349 A.2d 22, 41 (Del. Ch. 1975) (attorney not subject to liability "if through no fault of his own, he is unaware of all information possessed by his client and those working in conjunction with him").

⁹⁰ For example, in preparing an opinion on the exemption from registration of securities being sold by a small business client, absent suspicious circumstances, a lawyer is entitled to rely on the company's financial statements, stock transfer records, minutes, articles of incorporation and other contracts and documents. See *Fisk v. Newsum*, 9 Wash. App. 650, 513 P.2d 1035 (1973) (attorney entitled to rely on certified financial reports); *Riordan & Wragg, Examination of Corporate Books in Connection With Stock Offerings and Acquisitions*, 18 BUS. LAW. 677 (1963); *Small, The Lawyer's Responsibility as Draftsman*, 30 BUS. LAW. 81 (Special Issue 1975).

⁹¹ ABA FORMAL OPINION 335 (1974).

⁹² *Dillard South Constr. Co. v. Greene*, 337 So. 2d 841 (Fla. Dist. Ct. App. 1976).

A lawyer's negligent failure to even read a contract submitted for interpretation may be actionable notwithstanding that some reasonably careful lawyer, after reading the contract, might have given the same advice. In a matter requiring the exercise of judgment, a lawyer who thus is able to render passable advice blindfolded is liable, if, because he did so, the client is deprived of superior advice that would have resulted from an informed use of the lawyer's judgment.⁹³

The required standard of skill for competent representation is the same as that applicable to knowledge.⁹⁴ A skillfully drawn contract, for example, must include every important point agreed upon by the parties and every provision usually included in similar contracts; furthermore, a skillfully drawn contract is not ambiguous in any critical area.⁹⁵ At least one court has held that a contract drafter is liable in a malpractice action for the loss incurred by the client because of an avoidable ambiguity in the contract.⁹⁶

When lawyers undertake a task in an area ordinarily handled by a specialist, they will be held to the level of skill exercised by specialists in that area.⁹⁷ For example, if a tax specialist would advise a client to request an advance ruling from the Internal Revenue Service, a general practitioner who fails to advise the client of this option is exposed to sanctions if the tax consequences are different from the lawyer's opinion, and if the action

⁹³ *Id.* at 843.

⁹⁴ See Section II (A) *supra*.

⁹⁵ See *Stein v. Kremer*, 112 N.Y.S. 1087 (Sup. Ct. 1908) (failure of an employment contract to reflect one year term). Cf. *Schmidt v. Hinshaw, Culbertson, Moelmann, Hoban & Fuller*, 75 Ill. App. 3d 516, 394 N.E. 2d 559 (1979) (alleged failure to draft contract for sale of a business properly; summary judgment for the law firm upheld on grounds plaintiff failed to produce expert testimony on appropriate level of drafting skill). See generally Comment, *Attorney Malpractice in California: The Liability of a Lawyer Who Drafts An Imprecise Contract Or Will*, 24 U.C.L.A. L. REV. 422 (1976).

⁹⁶ *Palmer v. Nissen*, 256 F. Supp. 497 (S.D. Me. 1966) (sales contract and deed ambiguous as to inclusion of a 3.7 acre tract); See also *Heyer v. Flaig*, 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969); *Fabry v. Joy*, 104 N.J.L. 617, 141 A. 780 (1928); Annot., 55 A.L.R.3d 977 (1974). To be actionable the error must be material and rather obvious. The fact that a court interprets a contract differently from what the draftsman intended will not, by itself, justify sanctions against a lawyer. See *Denzer v. Rouse*, 48 Wis.2d 528, 180 N.W.2d 521, 525 (1970).

⁹⁷ See notes 68-78 and accompanying text *supra*.

on the ruling request would have revealed the difficulty.⁹⁸

There is one important distinction, however, between liability for lack of knowledge and liability based on a lack of appropriate legal skill. Courts consistently have held that lawyers are not liable for good faith errors of judgment.⁹⁹ Although the outside parameters of this immunity are not clearly defined, its essence seems to be that a lawyer who adequately prepares and makes a good faith effort to render a correct legal judgment will not be subject to sanctions if in fact it is later determined that judgment was mistaken. This issue has arisen most frequently in cases involving unsettled, doubtful or grey areas of the law. If proper research has been undertaken, a lawyer will not be subject to discipline or liable in malpractice if a later case renders the lawyer's opinion incorrect.¹⁰⁰ For example, in *Smith v. St. Paul & Marine Ins. Co.*,¹⁰¹ a lawyer researched the applicable law and advised a client that a particular state procedure would not adversely affect the tax liability of an estate. The Internal Revenue Service won a subsequent suit against an unrelated party on the issue and then assessed additional estate taxes against the estate. The client sued the lawyer for malpractice. The court, in absolving the lawyer, stressed the fact that at the time the advice was given the issue was unsettled and was one on which there was an honest difference of opinion by lawyers

⁹⁸ See Comment, *Legal Liability of the Professional Tax Practitioner*, 26 EMORY L. REV. 404, 410-11 at n. 33 (1977). Cf. *Yandall v. Baker*, 258 Cal. App. 2d 308, 65 Cal. Rptr. 606 (1st Dist. 1968) (opinion that corporate reorganization would result in long term capital gain was incorrect and the gain was ultimately taxed as ordinary income; malpractice claim, however, barred by statute of limitations); *Instrument Systems Corp. v. Whitman*, 77 Misc.2d 719, 354 N.Y.S.2d 514 (1974) (failure of stock option plan to qualify under I.R.C. § 422).

⁹⁹ See, e.g., *Smith v. St. Paul Fire & Marine Ins. Co.*, 366 F. Supp. 1283 (M.D. La. 1973), *aff'd per curiam*, 500 F.2d 1131 (5th Cir. 1974); *Brown v. Gitlin*, 19 Ill. App. 3d 1018, 313 N.E.2d 180 (1974); *Citizens Loan, Fund & Savings Ass'n v. Friedley*, 123 Ind. 143, 23 N.E. 1075 (1890); *In re Lohse*, 207 Kan. 36, 483 P.2d 1048 (1971); *Gimbel v. Waldman*, 193 Misc. 758, 84 N.Y.S.2d 888 (Sup. Ct. 1948); *Hodges v. Carter*, 239 N.C. 517, 80 S.E.2d 144 (1954); *Cook v. Irion*, 409 S.W.2d 475 (Tex. Civ. App. 1966). Cf. *Capital Bank Trust Co. v. Core*, 343 So. 2d 284 (La. Ct. App. 1977) (where bad faith or fraud no immunity; also no malpractice insurance coverage). See generally MALLEN & LEVIT §§ 212-216.

¹⁰⁰ See the authorities cited in note 99 *supra*.

¹⁰¹ 366 F. Supp. 1283 (M.D. La. 1973), *aff'd per curiam*, 500 F.2d 1131 (5th Cir. 1974).

familiar with the area.¹⁰²

C. Promptness

The most frequent complaint against lawyers is their failure to perform legal tasks in a prompt fashion. Client prejudice resulting from failure to take timely action with respect to litigation is the number one source of legal malpractice complaints.¹⁰³ Failure to complete legal assignments on time or to act within a reasonable period if no time limit is specified, are also among the most frequent complaints made against lawyers to disciplinary agencies.¹⁰⁴ Many of these cases involve representation of businesses. In two reported New York cases,¹⁰⁵ for example, lawyers were disbarred for failure to file articles of incorporation and to take other required action to properly form corporations.

Although procrastination by lawyers is an admittedly serious problem, it can be avoided with a well designed docket control and diary system and good manners. It should be the easiest component of competence to satisfy. Because it is so easily corrected, failure to timely complete legal tasks is inexcusable, and if a lawyer's failure to act prejudices a client's interest, severe sanctions should be imposed.¹⁰⁶ Even if adverse legal conse-

¹⁰² *Id.* A lawyer is not entitled to this protection if he has not done the appropriate research and preparation, even if the law is in fact unsettled, since he has not properly applied his skill. See, e.g., *Smith v. Lewis*, 13 Cal. 3d 349, 358-60, 530 P.2d 589, 595-97, 118 Cal. Rptr. 621, 627-28 (1975) (failure to research client's rights to former husband's pension); *Dillard Smith Const. Co. v. Greene*, 337 So. 2d 841 (Fla. Ct. App. 1976); *Muse v. St. Paul Fire & Marine Ins. Co.*, 328 So. 2d 698 (La. Ct. App. 1976); *Kozy Books, Inc. v. Stillman*, 19 App. Div. 2d 802, 243 N.Y.S.2d 266 (1963).

¹⁰³ See *Bridgman, Legal Malpractice—A Consideration of the Elements of a Strong Plaintiff's Case*, 30 S. CAROLINA L. REV. 213, 223 (1979) (estimated 45% of all malpractice claims involve missed time limitations).

¹⁰⁴ See *Marks & Cathcart, Discipline Within The Legal Profession: Is It Self Regulation*, 1974 U. ILL. L.F. 193, 212 (524 out of 713 disciplinary complaints filed against New York City lawyers in 1970 were based on neglect). *Steele & Nimmer, Lawyers, Clients and Professional Regulations*, 1976 AM. B.F. RES. J. 917, 954, 970-71, 975.

¹⁰⁵ *In re Harris*, 264 App. Div. 519, 35 N.Y.S.2d 790 (1942); *In re Kaufman*, 252 App. Div. 280, 299 N.Y.S. 157 (1937). In *Kaufman*, the clients were saddled with personal liability as a result of the attorney's neglect. In *Harris*, however, no mention was made of any prejudice to the clients.

¹⁰⁶ Neglect is a violation of DR 6-101(A)(3). See ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY 269-72 (1979); Annot., 80 A.L.R.3d 1240 (1977); Annot., 96 A.L.R.2d 823 (1964). See also PROPOSED MODEL RULE 1.2; Yarborough

quences do not occur, neglect and indifference at the very least undermine a client's confidence and trust in the lawyer.

D. Disclosures

Disclosure is a component of competence in two rather different senses. The first concerns the duty to consult with the client prior to taking action that legally binds the client. This first type of disclosure, dealt with in this section, involves the client's right to choose the course of action eventually taken. The second type of disclosure obligations involves conflicts of interest between a lawyer and a client or between two present or former clients. Conflicts of interest affect competence by creating situations where lawyers cannot give disinterested, and hence competent, advice. This connection between competence and conflicts of interest is examined more closely in the next section of this article.

A lawyer cannot bind a client without the client's informed consent. The sole exception to this is with respect to technical matters "not affecting the merits of the cause or substantially prejudicing the rights of a client."¹⁰⁷ The concept that the client has the ultimate authority to determine what objectives and means to pursue is equally applicable in both legal counseling and litigation. The lawyer's duty to consult with the client is arguably greater in a counseling situation, however, than during litigation because the counselor does not need to make the type of immediate decisions ordinarily made during the heat of a trial.¹⁰⁸ Although client pressure for instantaneous legal opinions

v. Cooper, 559 S.W.2d 917 (Tex. Civ. App. 1978) (actual and punitive damages for failure to timely advise a client on available methods of avoiding taxes by investing in a tax shelter real estate venture).

¹⁰⁷ EC 7-7. See also PROPOSED MODEL RULE 1.3. It is clearly established, for example, that a lawyer cannot settle a controversy without the consent of the client. See, e.g., *Clarion Corp. v. American Home Products Corp.*, 494 F.2d 860, 864 (7th Cir. 1974), *cert. denied*, 419 U.S. 870, *rehearing denied*, 419 U.S. 1027 (1974); EC 7-7; ABA FORMAL OPINION 326 (1970); PROPOSED MODEL RULE 4.5.

¹⁰⁸ See *Berman v. Rubin*, 138 Ga. App. 849, 227 S.E.2d 802, 805 (1976); *Breedlove v. Turner*, 9 Mart. (O.S.) 353, 374 (La. 1821); *Byrnes v. Palmer*, 18 App. Div. 1, 45 N.Y.S. 479 (1897). Because of time constraints, lawyers involved in litigation are generally given wide latitude in making decisions and are not liable for mistakes of judgment made under the pressure of a trial. See MALLEN & LEVIT §§ 214, 324; Spiegel, *Lawyering and Client Decisionmaking: Informed Consent and The Legal Profession*, 128 U. PA. L. REV. 41 (1979).

is common, it is often possible to research the issues involved and later consult with the client. On the other hand, if a lawyer counseling a business client is faced with an imminent deadline through no fault of his own and the deadline cannot be delayed, then the counseling lawyer should be judged by the same standard as a litigator involved in a trial.

A corollary of the rule that the client has the ultimate decision making power is the notion that a lawyer must, unless the representation is terminated, accept the decisions made by the client.¹⁰⁹ This rule is subject to two important exceptions. First, a lawyer cannot knowingly counsel or assist a client to engage in fraudulent or otherwise illegal conduct.¹¹⁰ If he or she does, then the lawyer is not only subject to liability as an aider and abetter in the illegal conduct¹¹¹ but he or she is also subject to disciplinary sanctions.¹¹² These types of acts lie at the core of most suits for damages, injunctions, and disciplinary proceedings brought against lawyers for violation of the securities acts.¹¹³ The same principle, however, uniformly applies to all types of legal counseling. For example, a lawyer would be subject to sanctions if he or she acceded to a client's demand that a contract include a clause patently illegal, unconstitutional or unconscionable; or assisted a business client in a sham transaction that involved tax evasion or a fraud on the client's creditors.¹¹⁴ If the client insists

¹⁰⁹ EC 7-7 and 7-8; PROPOSED MODEL RULE 1.3. Failure to follow the instructions of the client has long been recognized as grounds for damages against a lawyer in a malpractice action. *See, e.g., Olfe v. Gorden*, 286 N.W.2d 573 (Wis. 1979); MALLEN & LEVIT § 218.

¹¹⁰ *See* EC 7-5; DR 1-102(A)(3) and (4); DR 7-102(A)(5), (6) and (7); PROPOSED MODEL RULES 2.3, 4.3.

¹¹¹ *See, e.g., SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 712-17 (D.D.C. 1978)(securities law violations); *Driscoll v. United States*, 376 F.2d 254 (1st Cir. 1967) (aiding and abetting income tax evasion).

¹¹² *See* ABA FORMAL OPINIONS 281 (1952); 314 (1965); 335 (1974); ABA INFORMAL OPINION 1386 (1977); *In re Hatch*, 10 Cal. 2d 147, 73 P.2d 885 (1937) (three year suspension for violation of State Blue Sky Statute). *Maryland Bar Ass'n v. Sugarman*, 273 Md. 306, 321 A.2d 1, *cert. denied*, 420 U.S. 974 (1974) (disbarment for aiding and abetting evasion of income taxes); Annot., 62 A.L.R.3d 252 (1975); Annot., 81 A.L.R.3d 1140 (1977).

¹¹³ *See* the authorities cited in notes 17-22 *supra*.

¹¹⁴ *See* PROPOSED MODEL RULE 4.3, which specifically proscribes such conduct. *See also* PROPOSED MODEL RULE 2.3(1), which prohibits giving advice to further a clearly illegal course of conduct by a client; ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK OP. 722 (1948), *cited as Op.* 2878 in *O. MARU & R. CLOUGH, DIGEST OF BAR ASSOCIATION ETHICS OPINIONS* 322 (1970) (It is im-

on pursuing an illegal course of action, then the attorney has no choice but to terminate the representation.¹¹⁵

Second, a lawyer not involved in representing a client in a matter pending before a tribunal may properly voluntarily withdraw from the representation under a variety of circumstances and by doing so avoid acceptance of the client's decisions.¹¹⁶ The circumstances under which permissive withdrawal is authorized in counseling situations are broader than when representing a client in court. For example, in a matter not involved in litigation, a lawyer may resign if the client insists on engaging in conduct that is legally improper or insists on a course of action that although lawful is contrary to the advice of the lawyer.¹¹⁷

Assuming a lawyer is either not required or does not want to resign, he or she must take appropriate action to minimize the legal risks of the client's chosen course of action even if he or she disagrees with the client's decision. For example, if a small business client insists on including in a contract a questionable but arguably valid clause that is not patently unconscionable then the lawyer must draft the clause in a manner that maximizes the chances it will be upheld if challenged.¹¹⁸ Similarly, a lawyer retained to advise a business client regarding a transaction's tax consequences should suggest language for the minutes approving the transaction setting forth the transaction's business purposes to forestall a subsequent IRS challenge. The lawyer should also

proper for a lawyer to insert a waiver of rights in a contract when he knows such waiver is against public policy and void as a matter of law).

The comment to Proposed Rule 4.3 states, however, that although it might be unwise, it is not ethically improper to draft a provision whose legality is subject to reasonable argument. PROPOSED MODEL RULES, at 92. Ethical impropriety only exists when the provision is as a matter of law illegal or unconscionable. Thus, Rule 4.3 does not really represent a radical change from the provisions in the CPR prohibiting a lawyer from engaging in conduct or taking a position that is unwarranted under current law. See DR 1-102(A)(3)(4), DR 7-102 A(2), (5), (7), (8).

¹¹⁵ EC 7-5; DR 2-110 (B)(2); PROPOSED MODEL RULE 1.16 (a)(1).

¹¹⁶ DR 2-110(B)(2); PROPOSED MODEL RULE 1.16(b).

¹¹⁷ EC 7-8, 7-9; DR 2-110(c)(1)(b),(e); DR 2-110(c)(2); PROPOSED MODEL RULES 1.3(c), 1.5(b), 1.16(b).

¹¹⁸ This is basically an application of the lawyer's duty to represent the client diligently and zealously. See EC 7-5, 7-6; DR 7-101(A)(1) ("A lawyer shall not intentionally [f]ail to seek the lawful objectives of his client through reasonably available means permitted by law and the Rules of Professional Conduct."); PROPOSED MODEL RULE 1.5(a).

take other appropriate action to establish a record that is as favorable as possible to the client's position, though not materially inaccurate or misleading.¹¹⁹

The continued representation of the client and the appropriate action to implement the client's decision presupposes that the lawyer has fulfilled the obligation to consult with the client prior to the client's final decision. The precise scope of this duty to consult is not entirely settled. The ultimate test is whether the lawyer has supplied the client with the appropriate information with which to make an informed decision. The test is somewhat analogous to the doctrine of informed consent applicable to physicians and patients.¹²⁰ It involves at least four fairly distinct types of information: factual disclosure; disclosure of legal risks; disclosure of alternative courses of action; and disclosure of non-legal considerations.

1. Factual Disclosures

A lawyer must disclose to the client all the material facts discovered in the course of the representation. For example, in *Spector v. Mermelstein*,¹²¹ a lawyer who represented a business client in connection with a corporate loan of \$250,000 was held liable to the client for the amount of the loan on the grounds that he had failed to disclose to the client several material facts concerning the borrower's precarious financial condition. The court, however, denied an additional claim for recovery of a \$35,000 loan to another business that was also handled by the

¹¹⁹ See EC 7-6 (A lawyer "may properly assist his client in the development and preservation of evidence of existing motive, intent or desire; obviously he may not do anything furthering the creation or preservation of false evidence"); ABA FORMAL OPINION 314 (1965) (a lawyer is under no duty to disclose the weaknesses in his client's case; and "may freely in assisting with preparation of a return urge the statement of positions most favorable to the client just as long as there is a reasonable basis for those positions"). See generally Corneel, *Ethical Guidelines for Tax Practice*, 28 TAX. L. REV. 1 (1972); Rowen, *When May A Lawyer Advise A Client That He May Take A Position On His Tax Return?*, 29 TAX LAW. 237 (1976).

¹²⁰ See W. PROSSER, THE LAW OF TORTS § 32, at 165-66 (4th ed. 1971). See generally Rosenthal, *Evaluating the Competence of Lawyers*, 11 LAW SOC. REV. 257, 270-73 (1976); Spiegel, *Lawyering And Client Decisionmaking; Informed Consent And The Legal Profession*, 128 U. PA. L. REV. 41 (1979).

¹²¹ 361 F. Supp. 30 (S.D.N.Y. 1972), *rev'd on other grounds*, 485 F.2d 474 (2d Cir. 1973).

same lawyer, because of insufficient evidence indicating that the lawyer withheld material information about this particular transaction. In the course of his opinion, the judge stated:

A client is entitled to all the information helpful to his cause within his attorney's command. If an attorney negligently or willfully withholds from his client information material to the client's decision to pursue a given course of action, or to abstain therefrom, then the attorney is liable for the client's losses suffered as a result of action taken without benefit of the undisclosed material facts.¹²²

The duty to disclose includes facts discovered by the lawyer that indicate the client may have a legal problem in an area outside the scope of the particular engagement. For example, if a lawyer who is retained to give a business client an opinion on the tax consequences of a proposed transaction accidentally discovers that illegal stock sales are taking place, he or she could be held liable in malpractice and exposed to disciplinary sanctions if this additional information is not brought to the client's attention.¹²³

In short, no lawyer has ever been held liable for telling a client more than the client wants to know. There are a significant number of cases, however, imposing sanctions on lawyers who failed to fully disclose facts uncovered in the course of the representation.¹²⁴

¹²² 361 F. Supp. at 40.

¹²³ See *Owen v. Neely*, 471 S.W.2d 705 (Ky. 1971); 1136 Tenants' Corp. v. Max Rothenberg & Co., 36 App. Div. 2d 804, 319 N.Y.S.2d 1007 (1971), *aff'd mem.*; 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972).

¹²⁴ See, e.g., *In re Bartlett*, 283 Or. 487, 584 P.2d 296 (1978) (six month suspension in part for inadequate disclosures of facts to the client). *Spector v. Mermelstein*, 361 F. Supp. 30 (S.D.N.Y. 1972), *rev'd on other grounds*, 485 F.2d 474 (2d Cir. 1973), discussed at notes 121-123 and accompanying text *supra*; *Owen v. Neely*, 471 S.W.2d 705 (Ky. 1971); *Moser v. Western Harness Racing Ass'n*, 89 Cal. App.2d 1, 200 P.2d 7 (2d Dist. 1948) (failure to disclose accurate facts concerning a stock subscriber to the board of directors).

Facts discovered by an attorney after the client has taken a position that materially affects the legality of the position must also be disclosed to the client. The client should be advised to make disclosures to any third parties whose rights may be prejudiced. The attorney's disclosure duty is particularly strong where a written opinion of the attorney is involved. See DR 7-102(A)(5), which prohibits a lawyer from "knowingly" making a false statement of law or fact. See also PROPOSED MODEL RULE 4.2, which states that in conducting negotiations:

(b) A lawyer shall not make a knowing misrepresentation of fact or law, or fail to disclose a material fact known to the lawyer, even

2. Legal Risks

The legal implications of a transaction must be explained to a client in terms that the client can understand. This disclosure must include an explanation of the legal risks involved in the client's chosen course of action.¹²⁵ For example, in a recent New Jersey decision¹²⁶ a lawyer representing the shareholders of a corporation being sold to new investors was held liable for malpractice when mortgages given as security to the sellers were never properly executed and therefore were subordinated to other creditors of the purchasers. The court also held that the

if adverse, when disclosure is:

(2) Necessary to correct a manifest misapprehension of fact or law resulting from a previous representation made by the lawyer or known by the lawyer to have been made by the client

This situation occurs fairly frequently with respect to tax and securities matters. See ABA FORMAL OPINION 314 (1965) (a lawyer cannot mislead the Internal Revenue Service either by misstatement, silence, or through his client); Corneel, *Ethical Guidelines for Tax Practice*, 28 TAX. L. REV. 1, 14-16, 23-24, 28-30(1972) (mistakes on tax returns and related issues); Cooney, *The Registration Process: The Role of the Lawyer in Disclosure*, 33 BUS. LAW. 1329 (1978); Hoffman, *On Learning of a Corporate Client's Crime or Fraud—The Lawyer's Dilemma*, 33 BUS. LAW. 1389 (1978). The duty of the lawyer to resign or to disclose the facts to third parties if the client refuses to make a required disclosure, is discussed in Section II(D)(5) and accompanying text *infra*.

A lawyer also has a duty to advise a client of changes in the law which materially affect legal work done for the client. See ABA FORMAL OPINION 210 (1942); ABA INFORMAL OPINION 661 (1963). A lawyer can also advise existing clients of the need to review periodically their legal problems. *Id.* See also ABA FORMAL OPINION 307 (1962).

¹²⁵ The Proposed Model Rules would specifically mandate such disclosure. PROPOSED MODEL RULE 2.4 states that:

A lawyer who knows that a client contemplates a course of action which has a substantial likelihood of serious legal consequences shall warn the client of the legal implications of the conduct, unless a client has expressly or by implication asked not to receive such advice.

See also EC 7-5 and 7-8; Feil v. Wishek, 193 N.W.2d 218 (N.D. 1972)(malpractice liability for failure to advise business client of need to take action to avoid Bulk Sales Act problems in connection with the sale of a business); Theobald v. Byers, 193 Cal. App. 2d 147, 13 Cal. Rptr. 864 (1st Dist. 1961)(failure to inform lenders of the need to have a note and chattel mortgage acknowledged and recorded); Fowler v. American Fed. Tobacco Growers, Inc., 195 Va. 770, 80 S.E.2d 554 (1954)(failure to tell business client the legal consequences of a contract).

¹²⁶ Stewart v. Sbarro, 142 N.J. Super. 581, 362 A.2d 581 (1976).

lawyer was negligent in not explaining to his clients the legal risks involved in completing the closing without obtaining the required signatures. The court further held, however, that the lawyer was not liable for giving the purchasers the stock certificates at the closing because the clients were aware of their right to have them withheld but voluntarily consented to their delivery.

The protection afforded an attorney who makes proper risk disclosure is illustrated by *Gill v. Di Fatta*.¹²⁷ Gill, an attorney, represented Di Fatta, a developer in an abortive transaction to obtain permanent financing for a marina. Gill sued for his fee and Di Fatta counterclaimed for malpractice. The court held Gill was not liable for malpractice because he had adequately warned Di Fatta not to become involved with the lenders because of their high pressure tactics and the irregularities in the proposed commitment fee escrow arrangement. Nevertheless, Di Fatta insisted on going ahead with the transaction. When the loan ultimately fell through, Di Fatta was unable to recover the commitment fee. The lenders subsequently plead guilty to fraud, vindicating Gill's advice.¹²⁸

The risk disclosure rule is the reason for including appropriate reservations and qualifications in legal opinions.¹²⁹ For example,

¹²⁷ 364 So. 2d 1352 (La. Ct. of App. 1978).

¹²⁸ Interestingly, the court intimated that had the deal been consummated, Gill would have been liable for malpractice because of several rather blatant deficiencies in the legal documents that he had approved. *Id.* at 1356-57.

¹²⁹ On the attorney's responsibilities in drafting legal opinions see generally Albenda, Gillen, Burlingame, Landau, Watts, Richardson & McCann, *Legal Opinions Given In Corporate Transaction*, 33 BUS. LAW. 2389 (1978); Babb, Barnes, Gordons, & Kjellenberg, *Legal Opinions to Third Parties in Corporate Transactions*, 32 BUS. LAW. 553 (1977); Corso, *Opinions of Counsel: Responsibilities and Liabilities*, 17 CLEV.-MAR. L. REV. 375 (1968); Fuld, *Lawyers Standards and Responsibilities in Rendering Opinions*, 33 BUS. LAW. 1295 (1978); Fuld, *Legal Opinions in Business Transactions—An Attempt to Bring Some Order Out of Some Chaos*, 28 BUS. LAW. 915 (1973). For detailed guidelines in drafting opinions in loan and securities transactions and in auditors' requests for information see the following: *ABA Statement of Policy Regarding Lawyer's Response To Auditors' Requests For Information*, 31 BUS. LAW. 1709, 1737 (1976); Report, *Legal Opinions to Third Parties: An Easier Path*, 34 BUS. LAW. 1891 (1979); Report by Special Committee on Lawyer's Role in Securities Transactions, *The Association of The Bar of the City of New York*, 32 BUS. LAW. 1879 (1977); Subcommittee on Opinion Writing of the Massachusetts Bar Association Committee on Corporate, Banking and Business Law, *Omnibus Opinion for Use in Loan Transactions*, 61 MASS. L.Q. 109 (1976).

in one recent California case,¹³⁰ a court reversed a summary judgment in favor of a law firm in a malpractice action because a lawyer in the firm failed to disclose that some of the partners in a purported general partnership had told the lawyer that the business might in actuality be a limited partnership or a corporation. The plaintiff had apparently received an opinion stating without qualification that the business was a general partnership.

The outer limits of this disclosure duty are not altogether clear. The materiality of the information in the case discussed in the preceding paragraph and the duty of additional investigation are rather obvious. Assume, however, a situation where an attorney, after making a proper investigation, concludes that the facts and applicable law present no substantial legal risk and therefore makes no disclosure of the potential risk in a written opinion. If it turns out that later events make the opinion incorrect, can the lawyer be held liable for failing to disclose the risk? There is *dicta* in some old cases involving real estate title examinations indicating that the lawyer has a duty to disclose any encumbrance that might possibly affect the title.¹³¹ In *Smith v. St. Paul Fire & Marine Insurance Co.*,¹³² a recent case from Louisiana involving estate taxes, however, the Court indicated that the attorney will be protected in this situation if he or she in good faith concludes that the risk is remote. This is similar to the rule that protects a lawyer from an error of judgment when he incorrectly advises a client on an issue on which the law is unsettled.¹³³ After undertaking what the court concluded was adequate research, the lawyer in *Smith* advised the heirs of an estate that a state court proceeding peculiar to Louisiana would not affect the ability of an estate to use the alternate tax valuation date. The lawyer did not tell the clients that there were no

¹³⁰ *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz*, 57 Cal. App.3d 104, 128 Cal. Rptr. 901 (2d Dist. 1976).

¹³¹ See *Byrnes v. Palmer*, 18 App. Div. 1, 45 N.Y.S. 479, 482 (1897), *aff'd* 160 N.Y. 699, 55 N.E. 1093 (1899) (clear case of failure to properly examine a judgment); *Dodd v. Williams*, 3 Mo. App. 278, 282-83 (1877) (negligent failure to locate a void deed); *Gilman v. Hovey & Buchanan*, 26 M. 280, 290 (1858) (failure to discover a judgment which the attorney claimed was void). See generally MALLEN & LEVIT § 376; Annot. 59 A.L.R. 3d 1176 (1974).

¹³² 366 F. Supp. 1283 (M.D. La. 1973). *aff'd per curiam*, 500 F.2d 1131 (5th Cir. 1974).

¹³³ See notes 99-102 and accompanying text *supra*.

cases on point specifically upholding this position. A subsequent, unrelated case held, however, that use of the unique proceeding disqualified an estate from using the alternate tax valuation date. The clients thus had to pay a tax deficiency assessment. Nevertheless, the court dismissed the malpractice action against the lawyer. With respect to the charge that the lawyer should have revealed the lack of direct legal authority supporting his position, the court stated:

if the attorney has reason to believe, or should have reason to believe that there could be some adverse consequences from taking the course advised, he is obligated to so advise his client. But if there is no reasonable ground for him to believe that his advice is questionable, he certainly had no obligation to advise clients of every remote possibility that might exist.¹³⁴

3. Alternative Courses of Action

A third type of required disclosure obligates an attorney to disclose alternative courses of action to the client. Can a lawyer properly limit his or her advice to the specific question asked by the client, or must he or she also point out alternative methods of achieving the client's objective? While the current Ethical Considerations indicate the existence of such an obligation,¹³⁵ the Proposed Model Rules of Professional Conduct make it more explicit. Proposed Rule 1.4 states that a lawyer has the duty of "explaining the significant legal and practical aspects of the matter and foreseeable effects of alternative courses of action."¹³⁶

One case clearly substantiates the mandatory position taken in the Model Rules. In a 1975 decision,¹³⁷ the Indiana Supreme Court publicly reprimanded a lawyer for acceding to a client's request that, in connection with a contemplated business investment by the client, he be named as a joint tenant with right of survivorship on the client's savings account. The court held that

¹³⁴ *Smith v. St. Paul Fire & Marine Ins. Co.*, 366 F. Supp. 1283, 1290 (M.D. La. 1973).

¹³⁵ EC 7-5, 7-8.

¹³⁶ PROPOSED MODEL RULE 1.4 (a)(2). See also PROPOSED MODEL RULE 4.1, which requires a lawyer to keep the client fully informed of all relevant facts during the course of negotiations; and 5.1 (b), which requires a lawyer representing multiple clients to keep each client fully informed of all relevant considerations.

¹³⁷ *In re Kuzman*, 335 N.E.2d 210 (Ind. 1975).

the attorney had an obligation to explore with the client alternative methods of achieving the client's objective which would avoid giving the lawyer a personal stake in the funds. In the course of the opinion, the court made the following pertinent remarks:

It is not unusual for a client untrained in the laws to come into an attorney's office and state that he wants the attorney to form a corporation for him. If the attorney accedes and completes the forms without first exploring the sole proprietorship and partnership forms of business with the client, and the aspects of each, the attorney has failed to give the client the full and disinterested advice to which he was entitled and which the bar demands be given

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Since this statement was made in a disciplinary action, the implications are frightening, particularly for general practitioners who serve small businesses.¹³⁹ Nevertheless, the imposition of

¹³⁸ *Id.* at 211.

¹³⁹ Taken literally, this means that a lawyer would be guilty of malpractice and subject to possible disciplinary sanctions if, for example, he or she fails to provide the client with a comparison of the tax consequences of partnerships, regular corporations and subchapter S corporations, as well as the availability of ordinary loss treatment for section 1244 common stock. See Dewey, *Failure of Counsel To Qualify Stock in a Small Business Corporation For Ordinary Loss Tax Benefits*, 1978 DET. COLL. L. REV. 28.

A lawyer would also presumably be subject to sanctions if he or she failed to explain to the client how the disadvantages of each of the business forms can be minimized. For example, the use of a limited partnership can reduce the individual exposure to liability while a partnership business-continuation agreement can reduce the adverse legal consequences of dissolution caused by the withdrawal or death of a partner. A limited partnership with a corporate general partner can also give the partners virtually the same protection against personal liability as if they had formed a corporation, although there are significant risks with this procedure when the limited partners control the corporate general partner. See, e.g., *Delaney v. Fidelity Lease, Ltd.*, 526 S.W.2d 543 (Tex. S. Ct. 1975); Note, *Tax Classification of Limited Partnerships*, 90 HARV. L. REV. 745 (1977). Likewise, many of the problems faced by minority shareholders in a closely held corporation can be minimized by the use of high vote requirements, voting and management agreements, share transfer restrictions, buy-sell agreements, long term employment contracts and similar devices. See H. O'NEAL, *CLOSE CORPORATIONS* §§ 4.01-9.31 (2nd ed. 1971); *Id.*, *OPPRESSION OF MINORITY SHAREHOLDERS* §§ 8.01-8.14 (1975), 1980 Cum. Supp. at vi (several malpractice cases based on failure to protect minority shareholders have been reported).

The securities implications of the proposed venture would also have to be reviewed with the client. Investment interests other than corporate stock qualify as securities. Under the securities statutes a security is any investment in a

disciplinary and malpractice sanctions for failure to fully inform a small business client or, for that matter, any client, of the full range of available alternatives is salutary and based on sound legal authority. To be fully informed, the client must know both the existing alternatives and the legal risks attached to each, even in circumstances where the client has not requested this additional information.

4. Non-Legal Considerations

Frequently, a course of action that is legally unobjectionable involves substantial non-legal risks, such as a loss of good will, or an adverse impact on employee relations. Both the current Ethical Considerations and the Proposed Model Rules indicate that a lawyer has an obligation to inform the client of these practical considerations.¹⁴⁰ Unlike the three previously discussed disclosure obligations, however, this type of disclosure is merely permissible and not mandatory.

Under the Proposed Model Rules such advice need not be given if the circumstances indicate "it is evident that the client desires advice confined to strictly legal considerations."¹⁴¹ The Model Rules thus recognize that some business executives simply do not want their lawyers telling them what they should do, as opposed to what they can do, and relieve the lawyer from any non-legal disclosure duty when this is the case. When an inexperienced client requests that the lawyer restrict his advice to the legality of a transaction, however, "the lawyer's responsibility as advisor may include indicating that more may be in-

business venture made with an expectation of profit based on the efforts of others. 15 U.S.C. § 77 (b)(1) (1976); UNIFORM SECURITIES ACT § 2; SEC v. Howey Co., 328 U.S. 293 (1946).

This same type of comprehensive review of alternatives and the tax, securities and other legal implications of proposed transactions has to be undertaken each time the client requests advice. If the client's needs are beyond the lawyer's expertise then the lawyer would have to gain the necessary expertise or associate another lawyer who is proficient in the area. See Sections II (A) *supra* and IV *infra*.

¹⁴⁰ EC 7-5, 7-8; PROPOSED MODEL RULE 2.2. Of course, if the client has consummated the transaction before the lawyer is retained, the lawyer would not be subject to sanctions for failing to point out financial or other nonlegal risks. See Vitale v. Cayne Realty, Inc., 66 App. Div. 2d 388, 392 (1979).

¹⁴¹ PROPOSED MODEL RULE 2.2.

volved than strictly legal considerations."¹⁴² Available information indicates a high percentage of investors in small businesses are not sophisticated about business matters, much less the law.¹⁴³ The caveat in the Proposed Model Rules is certainly applicable to unsophisticated business clients. Nevertheless, since this particular disclosure obligation is not mandatory, a lawyer should not be subject to either malpractice liability or disciplinary sanctions for failure to inform the client of the relevant non-legal considerations. The duty exists and the wise counselor will fulfill the duty; but there is no penalty for failure to do so.

5. Disagreement With The Client's Decision

A related issue arises when an agent of a small business client refuses to follow the attorney's recommendations. Does the attorney then have the responsibility to report his recommendations to other persons in the organization? If he or she does give a second report and the decision is not changed, what are the lawyer's responsibilities?

A lawyer retained by the business represents the entity and not the directors, managers, officers, employees or owners.¹⁴⁴ An organization, however, can only operate through agents. For legal purposes it would seem that the agents who have the final policy making authority in the organization are the embodiment of the client.¹⁴⁵ In a corporation this authority is vested in the

¹⁴² PROPOSED MODEL RULE 2.2, Comment.

¹⁴³ See Mayer & Goldstein, *Small Business Growth Survival During the First Two Years*, 18 VAND. L. REV. 1749 (1965).

¹⁴⁴ EC 5-18; PROPOSED MODEL RULE 1.13(a); *U.S. Industries, Inc. v. Goldman*, 421 F. Supp. 7 (S.D.N.Y. 1966) (corporate general counsel does not by virtue of that position have any attorney-client relation with the directors). See generally Freeman *Opinion Letters and Professionalism*, DUKE L.J. 371, 374-76 (1973); Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under The Federal Securities Statutes*, 34 OHIO ST. L.J. 231, 253-57 (1973); Sonde, *The Responsibility of Professionals Under The Federal Securities Laws—Some Observations*, 68 NW. U. L. REV. 1, 9-14 (1973); Taylor, *The Role of Corporate Counsel*, 32 RUT. L. REV. 237, 241-50 (1979); Van Dusen, *Who is Counsel's Corporate Client?*, 31 BUS. LAW. 474 (1975).

¹⁴⁵ See ABA FORMAL OPINIONS 86 (1932) (general counsel cannot take part in controversies among shareholders); 202 (1940) (general counsel should disclose embezzlement by officer to board of directors of a trust company but cannot make disclosures to other persons); ABA INFORMAL OPINIONS 516 (1962) (even if general counsel resigns, he cannot represent a shareholder in a suit to dis-

board of directors.¹⁴⁶ In a partnership it is vested in the general partners.¹⁴⁷ In a proprietorship, it is obviously the proprietor. Reporting the matter to the policy making body is a logical step and some precedent exists for a rule requiring a lawyer to request such review.¹⁴⁸ This approach, however, presents several problems. First, the executive to whom the lawyer reports may attempt to prevent the matter from being reviewed by the board. Must the lawyer then approach members of the board in defiance of the executive's decision? Second, even if the matter is reviewed, the policy board may agree with the decision made by the executive. Frequently the executive involved in the original decision is also a member of the policy board. This is very likely the case in small, closely held corporations where many of the shareholders are also officers and directors. Additionally, in many cases, the issue may involve wrongdoing by the policy board itself. Owners who lack representation on the policy board, however, may not have received any information about the issue. If the lawyer knows this, should he or she make disclosure to this group even though it may involve disclosure of client confidences?

The Proposed Model Rules, incorporating principles developed primarily in securities cases and literature provide much more concrete direction on these issues than does the CPR. Proposed Rule 1.13¹⁴⁹ obligates the lawyer to take remedial steps

solve the corporation); 1056 (1968) (corporate general counsel can advise the president with respect to a proxy fight for control if the advice is legally sound and "not contrary to the interests of the corporation itself"); 1349 (1975) (house counsel cannot disclose bribery by its controlling stockholder-officer to the minority shareholders but "may" disclose the facts to the board of directors).

¹⁴⁶ See the citations in note 145, *supra*; MODEL BUSINESS CORPORATION ACT § 35.

¹⁴⁷ UNIFORM PARTNERSHIP ACT § 18(e).

¹⁴⁸ See ABA FORMAL OPINION 202 (1940); *In re Carter*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175, at 82,182-87; *The Code of Professional Responsibility and the Responsibility of Lawyers Engaged in Securities Law Practice - A Report by the Committee on Counsel Responsibility and Liability*, 30 BUS. LAW. 1289, 1293 (1975); Myers, *The Attorney-Client Relationship and the Code of Professional Responsibility: Suggested Attorney Liability for Breach of Duty to Disclose Fraud to the Securities and Exchange Commission*, 44 FORDHAM L. REV. 1113, 1131-32 (1976).

¹⁴⁹ The relevant portions of this Rule, undoubtedly one of the most controversial proposals in the Proposed Model Rules, are:

- (a) A lawyer employed or retained by an organization represents

when action or refusal to act "is a violation of law and likely to

the organization as distinct from its directors, officers, employees, members, shareholders, or other constituents.

(b) If a lawyer for an organization knows that an officer, employee, or other person associated with the organization is engaged in or intends action, or a refusal to act, that is a violation of law and is likely to result in significant harm to the organization the lawyer shall use reasonable efforts to prevent the harm. In determining the appropriate measures, the lawyer shall give due consideration to the seriousness of the legal violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization of the person involved, and the policies of the organization concerning such matters. The measures taken shall be designed to minimize disruption and the risk of disclosing confidences. Such measures may include:

- (1) Asking reconsideration of the matter;
- (2) Seeking a separate legal opinion on the matter for presentation to appropriate authority in the organization;
- (3) Referring the matter to higher authority in the organization, including, if necessary, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may take further remedial action, including disclosure of client confidences to the extent necessary, if the lawyer reasonably believes such action to be in the best interest of the organization.

The original formulation of this section in the working draft of the rules differed from the present version in several significant respects. See *BNA's Washington Memorandum Special Supplement—Working Draft of "Rules of Professional Conduct"*, Prepared By The American Bar Association's Commission On Evaluation Of Professional Standards 14 (1979). The most important difference is that the working draft mandated further action "including giving notice to the injured persons, making the lawyer's resignation known publicly, or reporting the matter to appropriate regulatory authority" if the board refused to follow the attorney's recommendations and the matter involved a clear violation of law. This, in effect, incorporated the SEC's original position in the National Student Marketing complaint. See *SEC v. National Student Marketing Corp.*, [1971-72 Transfer Binder] *FED. SEC. L. REP. (CCH)* ¶ 93,360, at 91,913-17. As drafted in the 1980 Proposed Model Rules, however, further disclosure action after board review is permissive rather than mandatory, except where required by law or the Rules. See also *PROPOSED MODEL RULE 1.7*, which sets forth the circumstances under which disclosure to persons other than the client is mandated. The comment reinforces this concept: "The interests protected are those of the directors, owners, and members

result in significant harm to the organization.”¹⁵⁰ Specific examples of appropriate action are asking for reconsideration, referring the matter to the organization’s highest authority or requesting that an additional legal opinion be prepared by an independent party. If, after such appropriate remedial steps, the policy making authority does not reverse the decision and the action or failure to act is “clearly a violation of law and is likely to result in substantial injury to the organization,”¹⁵¹ the lawyer

of the organization. The lawyer’s duty does not extend to third parties who may be injured by wrongful acts of the organization.” PROPOSED MODEL RULES, at 43-44. This is basically the position advocated by the American Bar Association Policy Statement adopted in response to the National Student Marketing complaint. *Statement of Policy Adopted by American Bar Association Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance by Clients with Laws Administered by the Securities and Exchange Commission*, 31 BUS. LAW. 543 (1975).

¹⁵⁰ PROPOSED MODEL RULE 1.13(b).

¹⁵¹ PROPOSED MODEL RULE 1.13(c). The difference, if any, between “likely to result in significant harm” in 1.13(b) and “likely to result in substantial injury” in 1.13(c) is not explained in the comment. One difference between the two subsections is, however, clearly significant. Under subsection (b), obligation to take further action exists when there “is a violation of law” that is likely to cause significant harm. Under subsection (c) further action is triggered only if the action or failure to act is “clearly a violation of law” that is likely to result in substantial injury. Although not explained in the comment, the difference seems to be that the lawyer has the obligation to take a matter involving a potential violation of law as far as the governing body and to explain to it the potential risks and remedial action. If however, a good faith defense exists, the lawyer is relieved of any mandatory responsibility to take any further action if the governing body rejects his recommendations. Of course, the lawyer could resign, as he or she is free to do in any counseling situation upon disagreement with the client’s position, and the lawyer will be protected against disciplinary or malpractice sanctions should he or she choose to make further permissible disclosures if such disclosures are permissible under the applicable ethical rules. If a good faith defense exists, however, a lawyer need not resign and ought not feel compelled to make further disclosures. See EC 7-8, 7-9; DR 2-110 (c)(1)(b),(c),(e); 4-101(c); PROPOSED MODEL RULES 1.7, 1.16. Cf. *Sherman v. Klopfin*, 32 Ill. App. 3d 529, 336 N.E.2d 219, 232 (1975) (one ground of malpractice liability imposed against a lawyer in a suit based on breach of fiduciary duty was his improper reporting of the client to the Internal Revenue Service); *In re Aydelotte*, 206 App. Div. 93, 200 N.Y.S. 637 (1923) (lawyer disciplined for threatening to disclose that client had not paid his taxes as a means of forcing the client to pay legal fees). Serious consideration of further action must be considered only when there is no colorable defense to the illegal activity. In that event, resignation from the engagement is required and further disclosure to persons associated with the entity and in some circumstances to third parties may be necessary. See PROPOSED MODEL RULE 1.16(a) (1) (“[A]

is authorized to take further remedial action. Resignation from the engagement¹⁵² and informing appropriate public authorities, a subject beyond the scope of this article,¹⁵³ are specifically mentioned in the comment.¹⁵⁴ The Rule¹⁵⁵ and the comment¹⁵⁶ state that the lawyer should at all times seek to minimize the risk that client confidences will be improperly disclosed. The comment further indicates that disclosure of the facts and risks to independent directors of a corporation and to the shareholders of a

lawyer shall withdraw . . . if continuing the representation will result in a course of conduct by the lawyer that is illegal or inconsistent with the rules of professional conduct"); 1.7(b) ("A lawyer shall disclose information about a client to the extent it appears necessary to prevent the client from committing an act that would result in death, or serious bodily harm to another person, and to the extent required by law or the rules of professional conduct."). Taken as a whole, the position adopted in the Proposed Rules appears to be reasonably consistent with the ABA Policy Statement adopted in 1975. *Statement of Policy Adopted by American Bar Association Regarding Responsibilities and Liabilities of Lawyers in Advising With Respect to the Compliance by Clients With Laws Administered by the Securities and Exchange Commission*, 31 BUS. LAW. 543, 545 (1975).

In one respect, however, Proposed Model Rule 1.13 changes or at least clarifies one important point. ABA Informal Opinion 1349 (1975) suggests that when a lawyer obtains confidences and secrets from an officer of the corporation disclosure to the board of directors is only discretionary even though clearly illegal conduct is involved. The opinion infers that the officer may be the "client" in this situation and the board of directors would be treated the same as an outside party for disclosure purposes. This position is clearly rejected in Proposed Rule 1.13, which requires disclosure to the board in these circumstances. This position is consistent with ABA FORMAL OPINION 202 (1940).

¹⁵² See the discussion in note 151 *supra*.

¹⁵³ See generally Hoffman, *On Learning of a Corporate Crime or Fraud—the Lawyer's Dilemma*, 33 BUS. LAW. 1389 (1978); Lorne, *The Corporate And Securities Advisor, The Public Interest, And Professional Ethics*, 76 MICH. L. REV. 425 (1978); Lowenfalls, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend In Standards of Care And Priorities of Duties*, 74 COLUM. L. REV. 412 (1974).

One of the main issues is whether disclosure to third parties is mandated by DR 7-102(B)(1), which requires disclosure when "A lawyer . . . receives information clearly establishing that his client has, in the course of the representation perpetrated a fraud . . . except when the information is protected as a privileged communication." Compare PROPOSED MODEL RULE 1.7(b), quoted in note 149 *supra*.

¹⁵⁴ PROPOSED MODEL RULES, at 43.

¹⁵⁵ PROPOSED MODEL RULE 1.13(b).

¹⁵⁶ PROPOSED MODEL RULE, at 42-43.

closely held corporation is proper and may even be necessary.¹⁵⁷ Neither of these courses of action would appear to involve a substantial risk of disclosures protected by the attorney-client privilege.¹⁵⁸

Charting a course of action that protects the client's confidences to the greatest extent possible but which also minimizes the attorney's exposure to malpractice and disciplinary action is exceedingly difficult. There are few precedents to guide the conscientious lawyer. Fortunately, careful explanation of the adverse legal and other consequences and the threat of resignation will often convince the client to follow the attorney's recommendations, thereby avoiding the possibility of disclosure to outsiders.¹⁵⁹ Bringing the matter forcefully and fully to the attention

¹⁵⁷ *Id.* at 43. Although not a defined term, "independent director" presumably includes any director who is not a principal or under the control of the principals in the transaction in question. For purposes of the review, these directors, are, according to the comment, the "highest authority" in the organization. PROPOSED MODEL RULES, at 42-43. In other words disclosure by the lawyer to the entire board and not merely to the "tainted" directors is required. If there are no independent directors or if the independent directors do not represent all of the minority interests in the organization, then disclosure to the minority interests would appear to be the only way to make disclosure of the problem to the entity. In this respect Rule 1.13 has the effect of limiting ABA Informal Opinion 1349 (1975), which held that general counsel to a corporation could not report bribery by an officer to minority shareholders. Under the rationale in the landmark case of *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 474 (1971), it would seem that shareholders in effect become the representatives of the entity when the directors engage in mismanagement or otherwise breach their fiduciary duties, or when the shareholders have the right to vote on the action in question. On this basis Proposed Model Rule 1.13 seems to advocate the correct legal position.

When the client is a limited partnership, then presumably disclosure should be made to the limited partners in circumstances where disclosure to shareholders would be appropriate. The rights of limited partners to bring suit or otherwise force the general partners to remedy any wrongdoing are not as well defined as are the remedies of oppressed minority shareholders *See, e.g., American Discount Corp. v. Saratoga West, Inc.*, 13 Wash. App. 880, 537 P.2d 1056 (Wash. App. 1975) (limited partners have no standing to maintain an action against general partners for double dealing); Note, *Procedures And Remedies in Limited Partners' Suits For Breach of the General Partner's Fiduciary Duty*, 90 HARV. L. REV. 763 (1977).

¹⁵⁸ *See, e.g., Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971); *Federal Savings and Loan Ins. Corp. v. Fielding*, 343 F. Supp. 537 (D. Nev. 1973); O'Neal & Thompson, *Vulnerability of Professional-Client Privilege In Shareholder Litigation*, 31 BUS. LAW. 1775 (1976).

¹⁵⁹ For an example of a case where threatened resignation and disclosure

of the client's policy making board is increasingly recognized as a mandatory first step when management personnel engage in conduct that might seriously harm the organization. If this does not work, resignation and further disclosures must be considered.

III. CONFLICTS OF INTEREST AND COMPETENCE

In order to render competent advice, a lawyer must be able to "exercise independent professional judgment."¹⁶⁰ This standard requires that an attorney not accept or continue representation when a disqualifying conflict of interest exists.¹⁶¹ Remedies for an improper conflict of interest include disqualification,¹⁶² denial of fees,¹⁶³ and disciplinary sanctions.¹⁶⁴

succeeded in forcing the client to make the necessary disclosures as well as later insulating the lawyers from a malpractice claim, *see* *Cohen v. Surrey, Karasik & Morse*, 427 F. Supp. 363 (D.D.C. 1977) (disclosure of prior criminal and bad check charges by one member of a shareholder group involved in a proxy fight to the other members of the group, which was represented by the defendant law firm).

¹⁶⁰ ABA CODE, Canon 5.

¹⁶¹ *See, e.g.*, DR 5-101, 102, 105. *See generally*, Aronson, *Conflict of Interest*, 52 WASH. L. REV. 807 (1977); Pierce, *The Code of Professional Responsibility In The Corporate World: An Abdication of Professional Self-Regulation*, 6 U. MICH. J.L. REF. 350 (1973); Note, *Legal Representation of Conflicting Interests: A View Toward Better Self Regulation*, 18 SANTA CLARA L. REV. 997 (1978); Note, *Unchanging Rules in Changing Times: The Canons of Ethics and Intra-Firm Conflicts of Interest*, 73 YALE L.J. 1058 (1964) (survey of major metropolitan firms indicated a widespread failure to comply strictly with the conflict rules in the Canons).

¹⁶² Motions to disqualify counsel on conflict of interest grounds have become quite common in recent years. Increasingly, courts have applied the conflict of interest rules in the ABA Code as the principal guide for determining the result of these motions. *See, e.g.*, *Woodruff v. Tomlin*, 593 F.2d 33 (6th Cir. 1979); *Lysick v. Walcom*, 258 Cal. App. 2d 136, 65 Cal. Rptr. 406 (1st Dist. 1968). *See generally* Fordham, *There Are Substantial Limitations on Representation of Clients in Litigation Which Are Not Obvious in the Code of Professional Responsibility* 33 BUS. LAW. 1193 (1978); Liebman, *The Changing Law of Disqualification: The Role of Presumption and Policy*, 13 NW. U.L. REV. 996 (1979); O'Toole, *Canon 9 of the Code of Professional Responsibility: An Elusive Ethical Guideline*, 62 MARQ. L. REV. 313 (1979); Comment, *The Ethics of Moving To Disqualify Opposing Counsel For Conflict of Interest*, 1979 DUKE L.J. 1310.

¹⁶³ *See e.g.*, *Anderson v. Eaton*, 211 Cal. 113, 293 P. 788 (1930); *Moser v. Western Harness Racing Ass'n*, 89 Cal. App.2d 1, 200 P.2d 7 (2d Dist. 1948); *Holcombe v. Steele*, 47 Tenn. App. 704, 342 S.W.2d 236 (1958).

A very high percentage of disqualifying conflicts of interest in litigation originate in counseling situations. One common situation is a lawsuit between two small business clients or between a present and a former small business client. Absent consent of both,¹⁶⁵ the firm¹⁶⁶ is disqualified from representing either party.¹⁶⁷ Many cases, however, involve more complex, subtle conflicts.¹⁶⁸

Difficult conflicts issues also arise in counseling. The two most frequent problems encountered by lawyers representing small businesses are: direct conflicts between the attorney and the client and representation of multiple clients. The major issues

¹⁶⁴ See, e.g., *Sheffield v. State Bar*, 22 Cal. 2d 627, 140 P.2d 376 (1943); *In re Banks*, 283 Or. 459, 584 P.2d 284 (1978); Annot., 17 A.L.R.3d 835 (1968).

Other sanctions for improper conflicts, which are viewed as a breach of the attorney's fiduciary duty of loyalty to the client, include rescission of contracts prejudicial to the client and actions for damages. See, e.g., *Crest Investment Trust, Inc. v. Comstock*, 23 Md. App. 280, 327 A.2d 891 (1974) and *Cultra v. Douglas*, 60 Tenn. App. 116, 444 S.W.2d 575 (1969)(rescission of contracts); *Ismael v. Millington*, 241 Cal. App.2d 520, 50 Cal. Rptr. 592 (3d Dist. 1966)(damages). See generally MALLEN & LEVIT § 99.

¹⁶⁵ EC 5-14 through 5-17; DR 5-101, 5-105; PROPOSED MODEL RULES 1.10; 5.1. In many situations, for example where a lawsuit involves a contract drafted by the firm, the firm could not represent either party regardless of consent. The conflict is simply too egregious. See, e.g., ABA Informal Opinion 564 (1962); 1322; 1441 (1979); *In re Lanza*, 65 N.J. 347, 322 A.2d 445; *Kelly v. Greason*, 23 N.Y.2d 368, 296 N.Y.S.2d 937, 244 N.E.2d 456 (1968); *Fordham*, *supra* note 159 at 1197-98, 1205, 1211. Cf., *Yablonski v. United Mine Workers*, 448 F.2d 1175 (D.C. Cir. 1971) (where actual conflict exists the same firm cannot represent multiple defendants in spite of consent).

¹⁶⁶ If any lawyer in the firm is disqualified, then the entire firm is disqualified. DR 5-105(D). This rule has caused considerable practical difficulties in situations where associates switch firms and government attorneys join private law firms. See, e.g., *Armstrong v. McAlpin*, 606 F.2d 28 (2d Cir. 1979); *Silver Chrysler Plymouth, Inc. v. Chrysler Motors Corp.*, 518 F.2d 751 (2d Cir. 1975). See generally *Lacovara, Restricting the Private Law Practice of Former Government Lawyers*, 20 ARIZ. L. REV. 369 (1979); *Liebman*, *supra* note 162. Rule 7.1 of the Proposed Model Rules is somewhat less stringent than the ABA Code, at least as far as lawyers switching firms is concerned.

¹⁶⁷ See, e.g., ABA INFORMAL OPINION 564 (1962); 891 (1965); 1322 (1975); 1323 (1975); *IBM Corp. v. Levin*, 579 F.2d 271 (3d Cir. 1978); *Brennan's Inc. v. Brennan's Restaurants, Inc.*, 590 F.2d 168 (5th Cir. 1979); *In re Banks*, 283 Or. 459, 548 P.2d 284 (1978).

¹⁶⁸ See, e.g., *Westinghouse Elec. Corp. v. Kerr-McGee Corp.*, 580 F.2d 1311 (7th Cir. 1978), *cert. denied*, 439 U.S. 955 (1978); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 567 F.2d 225 (2d Cir. 1977).

raised by these problems are discussed below.

A. Serving as a Director and Other Attorney-Client Conflicts

Every lawyer knows that any business transaction in which a lawyer sells or buys property to or from an individual client, or a business controlled by an individual client, is subject to rescission unless the lawyer can prove that the transaction was fair and equitable and that the client knew of the attorney's involvement and gave informed consent to it.¹⁶⁹ The conflict and the potential for fraud in this situation are both obvious. The solution is also obvious. These transactions should be avoided if at all possible. If not possible, then the lawyer should insist that the client obtain independent advice on the transaction and create a record establishing the fair value of the property through an appraisal, or some other means. In addition, the lawyer may be liable for damages and subject to disciplinary sanctions.¹⁷⁰

Similar strict rules do not presently exist, however, for the lawyer who serves as a director or member of the policy board of a business client the lawyer either regularly represents as general counsel or in which the lawyer holds an equity or debt interest. Although the conflict with the client is more indirect and subtle, the potential impairment of the lawyer's ability to provide independent professional judgment is just as great as in cases involving direct business transactions with a client.

The practice of utilizing general counsel as corporate directors is quite common¹⁷¹ and presently entails no ethical impropri-

¹⁶⁹ DR 5-104(A). *See, e.g.*, In Re Gamble, 122 Ariz. 2, 592 P.2d 1268 (1979); Sodikoff v. State Bar, 14 Cal. 3d 422, 535 P.2d 331, 121 Cal. Rptr. 467 (1975); Gold v. Greenwald, 247 Cal. App. 2d 296, 55 Cal. Rptr. 660 (2d Dist. 1967); Sherman v. Klopfer, 32 Ill. App. 3d 519, 336 N.E.2d 219 (1975); In re Bartlett, 283 Or. 487, 584 P.2d 296 (1978); Annot., 35 A.L.R.3d 674 (1971). Compare ABA Code DR 5-104(A) with PROPOSED MODEL RULE 1.9(a) ("A lawyer shall not enter into a business financial, or property transaction with a client unless the transaction is fair and equitable to the client."). *See generally* MALLEN & LEVIT §§ 100-102; Wolfram, *The Code of Professional Responsibility As a Measure of Attorney Liability in Civil Litigation*, 30 S. CAROLINA L. REV. 281, 305-06 (1979).

¹⁷⁰ *See* the authorities cited note 169, *supra*.

¹⁷¹ *See* Forman & Brown, *Board Chairmen, Presidents, Legal Counsel: Some Aspects of Their Jobs*, 4 CONF. BOARD REC. 83 (1967); McDaniel, *Ethical Problems of Counsel for Big Business: The Burden of Resolving Conflicting Interests*, 38 A.B.A.J. 205, 257 (1952); Riger, *The Lawyer-Director—A Vexing Problem*, 33 BUS. LAW. 2381 (1978); Note, *Should Lawyers Serve as Directors*

ety.¹⁷² The Proposed Model Rules would, however, substantially restrict this practice. Under Proposed Rule 1.9, a lawyer could serve as both general counsel and a director only if all the investors consent to the arrangement, or if unanimous consent is not feasible, "when doing so would not involve serious risk of conflict between the lawyer's responsibilities as general counsel and those as director."¹⁷³ The Proposed Rule would apply to both house counsel and to a lawyer "who acts on a regular and continuing basis as principal legal advisor to an organization."¹⁷⁴ Assuming the Proposed Rule is adopted, general counsel for most close corporations would still be able to serve as director since it will be possible to obtain unanimous consent from all of the investors.

Irrespective of the adoption of the Proposed Rule regarding lawyer-directors, a lawyer should consider several factors before agreeing to serve as a director of a client. First, it is unquestionably more difficult to maintain the requisite independence and loyalty to the corporate client when the lawyer occupies a position as a director. The lawyer-director must be able to withstand peer pressure from fellow directors and put aside consideration of potential personal liability.¹⁷⁵ Second, a lawyer-director and his or her law firm will be disqualified as the corporation's counsel in litigation more frequently than if the lawyer were not a director, due to the large number of suits—including derivative suits—in which the directors are named as a party.¹⁷⁶

of Corporations for Which They Act As Counsel? 1978 UTAH L. REV. 711, 722 at n.47 (81% of lawyers in Salt Lake City responding to a survey were currently or in the past had served as directors to client corporations).

¹⁷² ABA INFORMAL OPINION 930 (1966) holds that an attorney can properly serve both as a director and lawyer for a bank.

¹⁷³ PROPOSED MODEL RULE 1.9 (f)(2).

¹⁷⁴ PROPOSED MODEL RULES, at 34. The main impact of the Proposed Rule will be on law firms that act as general counsel for large publicly held companies. In both large and small companies, however, a lawyer who represents the organization only occasionally or whose representation is confined to specific or specialized matters, such as legal questions involving patents, could properly serve as a director without meeting either the consent or the no serious conflict tests in the Proposed Rule.

¹⁷⁵ See Knepper, *Liability of Lawyer-Directors*, 40 OHIO ST. L.J. 341, 349-54 (1979); Ruder, *The Case Against The Lawyer-Director*, 30 BUS. LAW. 41, 51-22 (1975).

¹⁷⁶ The law firm may also be disqualified from representing the corporation because of a conflict of interest even if it has no representative on the board.

Third, information received by the lawyer at a directors meeting—even though given in the lawyer's capacity as the corporation's general counsel—may not be protected by the attorney-client privilege.¹⁷⁷ Fourth, the attorney is exposed to individual liability for actions taken as a director and, as a lawyer, may be held to a higher degree of due diligence than non-lawyer directors.¹⁷⁸ The potential liability to the law firm, the cost of director's and officer's liability insurance and the increase in the cost of malpractice insurance are certainly factors to be considered when a lawyer is asked to be a board member. The danger of potential liability further increases whenever the client engages in any securities transactions. The liability risk under either state or federal securities law is not as great in most small businesses as it is in publicly held concerns.

Fifth, general counsels for small businesses are placed in awkward situations should there be any dispute among the investors. Lawyer-directors will often be unwittingly forced into the role of tie-breaker or arbitrator. The proper role of a director-general counsel when shareholders in a family corporation become embroiled in a bitter dispute, as they often do, is acutely frustrating.¹⁷⁹

Sixth, a lawyer can attend board meetings and give his input on legal issues without being a voting member of the board. The

See, e.g., Brennan's Inc. v. Brennan's Restaurants, Inc., 590 F.2d 168 (5th Cir. 1979) (suit between client and spinoff corporation over use of a trademark); Messing v. FDI, Inc., 439 F. Supp. 776 (D.N.J. 1977) (law firm disqualified from representing corporation in a derivative suit); National Texture Corp. v. Hymes, 282 N.W.2d 890 (Minn. 1979) (suit between a corporation and a former corporate officer over rights to a patent).

¹⁷⁷ The attorney-client privilege does not apply to business advice. *See, e.g.,* Zenith Radio Corp. v. Radio Corp. of America, 121 F. Supp. 792, 794 (D. Del. 1954). When the lawyer is also a director, determining what advice is protected is much more difficult. *See* Kneeper, *supra* note 175, at 344-45, 354-55; O'Neal & Thompson, *Vulnerability of Professional-Client Privilege in Shareholder Litigation*, 31 BUS. LAW. 1775, 1792-93 (1976).

¹⁷⁸ *See, e.g.,* Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 554 (E.D.N.Y. 1971); Escott v. Bar Chris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Kneeper, *supra* note 175, at 346-54; *Lawyers As Directors-Panel Discussion*, 30 BUS. LAW. 41, 42-50, 55-58 (1975).

¹⁷⁹ *See* M. MACE, DIRECTORS: MYTH AND REALITY 163 (1971) ("The ties of family loyalty are exceedingly deep, blood is really thicker than water, and the unwary outside director can learn too late that identification with one side or the other may lead to disqualification and the end of his possible usefulness to family problems.")

argument that a voting board member's opinions carry more weight is unpersuasive. Directors know they must carefully consider the legal advice of their legal counsel.¹⁸⁰

Finally, a high percentage of cases where lawyers have been held civilly or criminally liable or disciplined for the role they played in securities and other business transactions have involved situations where the attorney was both general counsel and a director.¹⁸¹ In many of these cases confusion between the roles of lawyer and director led to the downfall.¹⁸² The potential impairment of independent judgment is thus often subtle and unintentional but always dangerous and ever present. The wisest course of action, it would seem, is simply to avoid the situation altogether.

Just as lawyers should be reticent about becoming directors, they should also exercise similar caution in accepting an interest in a client's business as a legal fee¹⁸³ or in investing significant

¹⁸⁰ The ability of the lawyer to attend board meetings as an invited guest also undercuts the argument, frequently made by corporations trying to persuade general counsel to come on the board, that being a director is necessary to avoid delays in resolving legal problems that arise during board meetings.

¹⁸¹ See, e.g., *Delamo v. Kitch*, 542 F.2d 550 (10 Cir. 1976); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978)(attorney for Interstate); *In re Keating, Muething & Klekamp*, [1979 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶ 82,124; *In re Carter*, [1979 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶ 82,175; *In re Murphy*, 15 Cal. 3d 533, 542 P.2d 12, 125 Cal. Rptr. 276 (1975); *Strahan v. Rodney*, 97 Cal. App. 2d 448, 217 P.2d 711 (2d Dist. 1950); *Rowan v. LeMars Mutual Ins. Co.*, 282 N.W.2d 639 (Iowa 1979)(attorney had been promised a directorship); *Adams v. American Western Securities, Inc.*, 265 Or. 514, 510 P.2d 838 (1973); *State v. Rogers*, 226 Wis. 39, 275 N.W. 910 (1937).

¹⁸² The cases cited in note 180 *supra* were selected with this thought in mind.

¹⁸³ See *In re Kuzman*, 335 N.E.2d 210 (Ind. 1975) (attorney, who took 20% of the stock valued at \$200,000 as his fee for organizing a corporation, was publicly reprimanded on grounds that the fee was excessive; the fact that the attorney gave up his right to the stock considered as a mitigating factor); *Sparkman & McLean Co. v. Darber*, 4 Wash. App. 341, 481 P.2d 585 (1971) (mortgage on corporate property as security for fee in handling a merger for a financially troubled business client held void; the note was held valid, however).

Receiving fees for activities other than legal services in addition to regular legal fees raise some of the same issues. See *Delamo v. Kitch*, 542 F.2d 550 (10th Cir. 1976)(attorney received a 3% broker's commission in addition to his fee); *Spector v. Mermelstein*, 361 F. Supp. 30 (S.D.N.Y. 1972), *rev'd on other grounds*, 485 F.2d 474 (2d Cir. 1973)(attorney for lender paid 3% of borrower's

amounts of money in a client's business.¹⁸⁴ Both are apparently common practices throughout the country. The larger the investment the greater the potential conflict of interest.¹⁸⁵ These problems, along with problems of restricted marketability of the stock¹⁸⁶ and complex tax considerations,¹⁸⁷ make equity investments in small business clients undesirable and professionally risky.

B. Multiple Representation

A lawyer counseling small business clients will fairly routinely be faced with multiple representation problems in a number of different contexts. Although the CPR generally prohibits dual representation of parties involved in litigation, representation of multiple clients with differing interests is permissible in non-litigation matters "if it is obvious that . . . the attorney can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of his independent professional judgment on behalf of each."¹⁸⁸ While the precise meaning of

stock as a broker's fee).

¹⁸⁴ It would clearly be improper for a lawyer to persuade the client to allow the lawyer to invest in the client's business. EC 5-3. *Cf.* ABA FORMAL OPINION 279 (1949)(unethical for an attorney to receive stock as a fee in a corporate client that was engaged in litigation to obtain an FCC license); DR 5-103(A) (prohibits acquisition of a proprietary interest in a pending lawsuit).

¹⁸⁵ *See, e.g.,* In re Kuzman, 335 N.E.2d 210 (Ind. 1975)(20% of stock in corporation held improper fee). The larger the investment, the greater the chances a court will view the transaction as a suspect joint venture with the client rather than as an arm's length transaction. *See* notes 169-170 and accompanying text *supra*.

¹⁸⁶ Unless a more general exemption is available the interest would be subject to the restrictive resale requirements of Rules 144 and 237. 17 C.F.R. §§ 230.144, 230.237 (1979). *See generally* Blumenthal, *SEC Exemption From Registration—A New Look*, 45 U. CIN. L. REV. 367 (1976); Thomforde, *Exemptions From SEC Registration for Small Businesses*, 47 TENN. L. REV. 1, 37-44 (1979).

¹⁸⁷ Under I.R.C. § 83 the value of the stock would be taxable "in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable." The illiquidity of the interest means that in all likelihood the money to pay the tax will have to come from other sources.

¹⁸⁸ DR 5-105(C). The ABA Code defines "differing interests" as including "every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be a conflicting, inconsistent, diverse, or other

this language is far from clear, at a minimum it seems to require that, before obtaining the necessary consent of the parties, the attorney must be convinced that he or she can represent the interests of each of the clients with exactly the same loyalty and degree of independence and impartiality as if each were represented by separate counsel.¹⁸⁹ In addition, Ethical Consideration 5-15 requires that an attorney "resolve all doubts against the propriety of the representation."¹⁹⁰ The Proposed Model Rules incorporate the substance of these guidelines, although the formulation is quite different.¹⁹¹

Frequently, the investors in a new business venture will request a single lawyer both to form the business and to act as its general counsel. Sometimes the lawyer will have represented one or more of the investors in other matters. Regardless of the prior representation, however, the situation presents the lawyer with difficult ethical and practical problems. In fact, prior representation may make the problems even more acute.¹⁹²

interest." ABA CODE, Definitions. *See also* EC 5-15, which after pointing out that there are only a few situations where representing multiple parties in litigation would be permissible, states: "[o]n the other hand, there are many instances in which a lawyer may properly serve multiple clients having potentially differing interests in matters not involving litigation"; EC 5-16, and EC 5-19, which define the disclosure and consent obligations required prior to undertaking multiple representation; ABA FORMAL OPINION 160 (1936); 224 (1941) (representing both corporation and an individual in drafting a contract); ABA INFORMAL OPINION 973 (1967) (representing parent and related corporations).

¹⁸⁹ *See, e.g.,* *Ishmael v. Millington*, 241 Col. App. 2d 520, 528, 50 Cal Rptr 592, 597 (3d Dist. 1966); *Hill v. Okay Constr. Co.*, 252 N.W.2d 107, 117 (Minn. 1977). As discussed in note 165 *supra*, there are some circumstances when the conflict is so blatant that requesting consent would be improper. In these cases a lawyer "obviously" could not adequately represent the interests of all the parties.

¹⁹⁰ ABA CODE, EC 5-15.

¹⁹¹ *See* PROPOSED MODEL RULES 1.5, 1.8, 1.9, 2.1, 5.1.

¹⁹² Proposed Model Rules 5.1(a)(3) requires that a lawyer representing multiple clients "act impartially and without improper effect on other services the lawyer is performing for any of the clients." The comment states:

A lawyer should not act as intermediary when the lawyer's impartiality might reasonably be questioned. For example, if a lawyer has acted as counsel for one of the clients for a long period and in a variety of matters, it would be difficult for the lawyer to be impartial between that client and one to whom the lawyer had only recently been introduced.

PROPOSED MODEL RULES, at 97.

Inevitably, a number of potential conflicts exist in this situation. Typically, some participants contribute primarily know-how and very little tangible property while others invest most of the necessary capital. The potentially differing interests of the parties concerning the amount and type of stock or other ownership interest each party is to receive are obvious. Invariably there will be potential conflicts concerning the amount of control over the management of the business each of the investors should have. This problem exists not only when the amounts of tangible property being invested in the business differ, but also when one or more of the capital investors does not want to actively participate in the every day business of the company, but still insists on participating in management or in receiving a higher percentage of the profits than is agreeable to the other investors. Other potential conflicts concern the disposition of an ownership interest if investors retire, leave the business, become disabled, die, or desire to give their stock to one or more family members. These potential conflicts exist not only in cases where all investors are members of a single family, long time friends or business associates, but also in situations where they have had no prior business relationship. The best interests of a husband and wife or a parent and child may differ. Practitioners often find a family business potentially more difficult to deal with than one where investors are total strangers. Frequently, it is more difficult to convince family members or friends that conflicts exist and that they must be discussed openly and frankly.

Before a lawyer decides to undertake the representation, all potential conflicts must be discussed with the participants and each of them must voluntarily consent to the proposed legal arrangements.¹⁹³ The leading case on the duty to disclose when representing both the buyer and seller in a real estate transaction, *In re Kamp*,¹⁹⁴ states:

Full disclosure requires the attorney not only to inform the pro-

¹⁹³ EC 5-15, 5-16, 5-19; DR 5-105(C). PROPOSED MODEL RULE 5.1(a)(4); ABA FORMAL OPINIONS 160 (1936); 224 (1941); ABA INFORMAL OPINION 1332 (1975). See generally, *Representation of Multiple Clients*, 62 A.B.A.J. 648 (1976); *Business Planning and Professional Responsibility*, 8 PRAC. LAW. 17 (Jan. 1962). Somewhat less detailed disclosure is necessary when all the clients are sophisticated investors than when one or more of them is inexperienced in business or legal matters. See, e.g., *In re Farr*, 264 Ind. 153, 340 N.E.2d 777, 785 (1976).

¹⁹⁴ 40 N.J. 588, 194 A.2d 236 (1963).

spective client of the attorney's relationship to the seller, but also to explain in detail the pitfalls that may arise in the course of the transaction which would make it desirable that the buyer have independent counsel. The full significance of the representation of conflicting interests should be disclosed to the client so that he may make an intelligent decision before giving his consent.¹⁹⁵

This process requires the lawyer to delve into the background and personality of each of the investors to determine their particular interests and objectives and the potential problems that may arise. It may also require separate conferences with one or more of the investors. Prior to obtaining their consent, the attorney must also make it clear that each investor is entitled to separate representation and that the attorney's feelings will not be hurt if any investor elects to obtain separate counsel.¹⁹⁶ In addition, the attorney must also inform the clients that multiple representation may vitiate the attorney-client privilege for each of them in any matter involving the business venture.¹⁹⁷ The consequences of this waiver should then be discussed. Further, the clients must be warned that if an actual conflict arises and cannot be amicably resolved, the attorney will have to withdraw from the representation.¹⁹⁸ Finally, depending on the circumstances, it may be desirable to obtain the clients' consent in writing.¹⁹⁹

Because of the inherent additional burdens of disclosure, arbitration and impartiality involved in multiple representation when a business is being organized, many law firms have adopted a blanket policy against it. A majority of lawyers, however, continue to undertake multiple representation if investors,

¹⁹⁵ *Id.* at 595-96, 194 A.2d at 240.

¹⁹⁶ EC 5-16, 5-19; ABA FORMAL OPINION 224 (1941).

¹⁹⁷ The joint attorney exception to the attorney client privilege is well established. See 8 J. WIGMORE, EVIDENCE § 2312 (McNaughton rev. 1961); *Brennan's Inc. v. Brennan's Restaurant, Inc.*, 590 F.2d 168 (5th Cir. 1979); *Grand Trunk W.R.R. v. H.W. Nelson Co.*, 116 F.2d 823, 835, *rehearing denied*, 118 F.2d 892 (6th Cir. 1941); *Billias v. Panageotou*, 193 Wash. 523, 76 P.2d 987 (1938) (partnership).

¹⁹⁸ EC 5-15; PROPOSED MODEL RULES 5.1, 5.2. The issue of continued representation of one of the parties after withdrawal from representing the entire group of clients is discussed at notes 209 through 212 and accompanying text *infra*. See also notes 165 and 188 *supra*.

¹⁹⁹ The California State Bar Rules specifically require that written consent be obtained. Rule 5-102(B) of the CALIFORNIA RULES OF PROFESSIONAL CONDUCT, *supra* note 3.

after due disclosure, request it. The exception to this occurs when lawyers feel their ability to render independent advice to each of the participants may be compromised by one or more factors, for example, long time representation or close personal or business ties with one of the investors.²⁰⁰ Lawyers justify multiple representation in this situation on several grounds. Some feel that the conflicts are only potential and not actual. Also, in the vast majority of cases involving investors in small businesses, the additional expense of separate representation is an unreasonable burden that if insisted upon, may economically force the participants to forego any legal representation. Furthermore, the essential task involved in establishing a new business is to fashion a legal structure that is fair to all the investors. The presence of more than one lawyer will often impede this process, particularly if the other lawyers adopt an adversarial position on each issue.

Obtaining the informed consent of the clients at the time the engagement is undertaken is essential, but will not by itself insulate the attorney from exposure to sanctions. The attorney must, in addition, represent each of the parties in a competent, impartial manner throughout the entire course of the representation. As one court recently stated:

An attorney who undertakes to represent at the same time adverse parties in any type of legal relationship, whether contractual or otherwise, does not obligate himself to adhere to any higher duty or standard of care than if he endeavored to represent only one of those parties. On the other hand, he clearly owes no lesser duty to each of his clients, and he must protect the interests of each as zealously as if their interests were his sole responsibility.²⁰¹

To satisfy this standard, the attorney must fully explain to each party all of the facts and risks involved each time an important decision is to be made.²⁰²

The difficulties involved in meeting this exacting disclosure obligation are illustrated by *Crest Investment Trust, Inc. v.*

²⁰⁰ See Note 191, *supra*. See also Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 U. ILL. L.F. 1, 16-17.

²⁰¹ *Hill v. Okay Constr. Co.*, 252 N.W.2d 107, 118 (Minn. 1977).

²⁰² Failure to meet this standard can result in malpractice damages as well as disciplinary sanctions. See, e.g., *Ishmael v. Millington*, 241 Cal. App. 2d 520, 50 Cal. Rptr. 592 (3d Dist. 1966) (malpractice); *Rowen v. Le Mars Mut. Ins. Co.*, 282 N.W.2d 639 (Iowa 1979) (disgorgement of attorneys' fees and damages including \$25,000 punitive damages); *State v. Rogers*, 226 Wis. 39, 275 N.W. 910 (1937) (two year suspension).

Comstock.²⁰³ In *Crest*, an attorney who was a director and an officer, as well as legal counsel, for an investment company, drew up all the legal documents involved in a complex transaction in which the company made a sizable investment in a small business that raised animals for scientific laboratories. As part of the agreement, the Comstocks, who operated the business, conveyed their entire farm to a new corporation with the understanding that when an existing mortgage covering the property was paid, most of the property, including their personal residence, would be returned for \$1.00. The reconveyance was subject to an option in the Corporation to purchase 97 acres at \$500 per acre. The agreement also assured the Comstocks employment with the new corporation, stock options and bonuses. The business did poorly. Prior to putting any additional money into the operation, the original agreement was amended. The general counsel for the investment company again drafted all the legal documents. The amended agreement provided that the land was to remain permanently as an asset of the corporation, except that the Comstocks' residence and one acre would be re-conveyed to them after the mortgage on all of the property was repaid. The attorney told the Comstocks this change was necessary to prevent foreclosure on the mortgage. He neglected to tell them, however, that his company had previously guaranteed payment of the mortgage. The amended agreement also significantly reduced Mr. Comstock's bonus and stock benefits. The general counsel apparently handled all of the legal work involved for no fee. He told the Comstocks that he was acting as the lawyer for both sides and that they did not need their own separate counsel. The Comstocks subsequently sued to enjoin a foreclosure of the mortgage and to create a constructive trust of the land for their benefit. The Court summarily dismissed the attorney's contention that there was no attorney-client relation between the general counsel and the Comstocks.²⁰⁴ It then held that the

²⁰³ 23 Md. App. 280, 327 A.2d 891 (1974).

²⁰⁴ *Id.* at 290, 327 A.2d at 902. It is well established that no formal contract is necessary to create an attorney-client relationship. Nor is any payment of fees required. All that is legally required is a promise or reasonable expectation of legal services. *See, e.g., Stewart v. Sbarro*, 142 N.J. Super. 581, 362 A.2d 581 (1976) (attorney for buyers of a business held liable for malpractice to sellers for failing to obtain necessary signatures on mortgages as he had voluntarily promised); *Schwartz v. Greenfield, Stein and Weisenger*, 90 Misc. 2d 882, 396 N.Y.S.2d 582 (1977) (attorney for debtor held liable in malpractice to a credi-

original agreement was fair and that full disclosure of all the facts had been made prior to the time it was consummated. The amended agreement was held void, however, on the grounds of inadequate disclosure. The judgment restored to the Comstocks their original rights under the first agreement. The failure to disclose to the Comstocks the mortgage guarantee and their legal rights and remedial options was the decisive factor in the case.²⁰⁵

Another case that illustrates the disclosure problem in multiple client situations is *State v. Rogers*.²⁰⁶ In *Rogers*, the Wisconsin Supreme Court suspended a prominent securities lawyer, who, with consent, acted as counsel for both the underwriter and the issuer in a securities issue. The gravamen of the complaint was the lawyer's failure to disclose to the issuer that the funds collected by the underwriter were being improperly used. The

tor for failing to record a financing statement).

²⁰⁵ As to the amount of disclosure required the Court stated:

In the light of the foregoing, Mr. and Mrs. Comstock clearly required (a) a factual and financial analysis of the consequences of a mortgage foreclosure and (b) a careful exploration of available remedies by court action. With respect to a foreclosure, the necessary information would include (1) the then market value of the land; (2) the value of the buildings and equipment and their own residence; (3) the amount of any liens against the property and (4) determination of an approximate surplus after foreclosure, to which they as the original mortgagors would be entitled; or (5) a determination of a possible deficiency for which they might be liable.

Consideration of the remedies available to Mr. and Mrs. Comstock at that time would have involved an analysis of the merits of a suit or suits in equity to enjoin foreclosure by the mortgagee bank and/or the payment of the mortgage by Crest as guarantor, seeking to defeat Crest's rights of subrogation by the assertion of equitable rights accruing to the Comstocks under the 1966 contract with Crest; or the pursuit of the remedies of rescission or reformation of the 1966 agreement on the grounds, *inter alia*, that the contingency of nonpayment of the mortgage by Comstock, Inc. was never contemplated by the parties and hence not provided against.

This brief recital is sufficient to indicate that Mr. and Mrs. Comstock were entitled to more, at the hands of Mr. Kaplan, than the advice that foreclosure was inevitable and, in effect, that their capitulation to the terms of the November 30, 1967 agreement was their only alternative to financial ruin. 23 Md. App. at 295, 327 A.2d at 907.

²⁰⁶ 226 Wis. 39, 275 N.W. 910 (1937).

lawyer defended his nondisclosure on the grounds that, as general counsel, he had objected to the wrongful acts to the underwriter and had hoped to resolve the matter without any legal problems. The court held that, under the circumstances, the attorney could not continue in a neutral role but had an absolute duty of full disclosure to each party represented.²⁰⁷

These principles are incorporated into the Proposed Model Rules. Proposed Rule 5.1 requires that:

while serving as intermediary a lawyer shall explain fully to each client the decisions to be made and the considerations relevant to making them, so that each client can make adequately informed decisions.²⁰⁸

Proposed Rule 5.2 goes one step further and requires a lawyer to withdraw in a multiple client situation:

if any of the clients so requests, if the conditions stated in Rule 5.1 cannot be met, or if it becomes apparent that a mutually advantageous adjustment of interests cannot be made. Upon withdrawal, the lawyer may continue to represent any of the clients only to the extent compatible with the lawyer's responsibilities to the other client or clients.²⁰⁹

If withdrawal is required because of a serious conflict between the clients that can not be amicably and fairly resolved, then the attorney should not represent any of the clients with respect to the matters in dispute.²¹⁰ For example, if a small business' gen-

²⁰⁷ 226 Wis. at 44-48, 275 N.W. at 913-16.

²⁰⁸ PROPOSED MODEL RULE 5.1(b).

²⁰⁹ PROPOSED MODEL RULE 5.2. The conditions in Rule 5.1 are:

- (1) The possibility of adjusting the clients' interests is strong; and
- (2) each client will be able to make adequately informed decisions in the matter, and there is little likelihood that any of the clients will be prejudiced if the contemplated adjustment of interests is unsuccessful; and (3) the lawyer can act impartially and without improper effect on other services the lawyer is performing for any of the clients; and (4) the lawyer fully explains to each client the implications of the common representation, including the advantages and risks involved, and obtains each client's consent to the common representation.

²¹⁰ EC 5-15; PROPOSED MODEL RULES 5.1(a)(3), 5.2. It is questionable whether it would be possible for a lawyer to represent one of the parties under a waiver agreement allowing the attorney to do so. *See Westinghouse Elec. Corp. v. Gulf Oil Corp.*, 588 F.2d 221 (7th Cir. 1978) (a waiver, no matter how broadly worded, cannot be used to justify use of confidential information); *In re Boone*, 83 F. 944 (C.C.N.D. Cal. 1897) (release by client did not operate to allow attorney to be hired by the opponent). *See also* ABA INFORMAL OPINION

eral counsel drafts a contract for a company executive,²¹¹ he or she would be disqualified from representing either the business or the executive in litigation involving the contract.²¹² The general counsel could, however, continue to represent the business or the executive in other unrelated matters.²¹³

Awkward conflicts for small business attorneys often arise when outsiders or minority shareholders attempt a takeover or when serious disputes among the investors lead to deadlock, an attempted squeeze out, split up, dissolution, or litigation.²¹⁴ Since the attorney is legally counsel for the business entity,²¹⁵ and since present management embodies the entity, the attorney is in effect cast in the role of counsel to the director or other managers. The ABA Committee on Professional Ethics has, for example, ruled that in a proxy fight it would be proper for General Counsel to the Corporation to advise management but improper to advise minority shareholders.²¹⁶ Where those in con-

1441 (1979), which holds that it would be improper for an attorney to continue to represent the manufacturer in a products liability suit if an actual conflict developed between the manufacturer and the retailer of the product even if an agreement to that effect had been signed at the time the joint representation was undertaken.

²¹¹ Such representation is quite common. Pointing out the potential conflicts, advising the individual of his or her rights to independent counsel and obtaining the individual's consent are, of course, necessary before undertaking the assignment. See note 192 and accompanying text *supra* and ABA FORMAL OPINION 224 (1941). Proposed Model Rule 1.13(d) adds disclosure "to an appropriate official of the organization other than the person so represented" to the list of prerequisites.

²¹² See ABA FORMAL OPINION 71 (1932); ABA INFORMAL OPINION 1322 (1975); *Cord v. Smith*, 338 F.2d 516 (9th Cir. 1964); *In re Evans*, 113 Ariz. 458, 556 P.2d 792 (1976); *Auseon v. Reading Brass Co.*, 22 Mich. App. 505, 177 N.W.2d 662 (1970); *In re Mumford*, 285 Or. 559, 591 P.2d 1377 (1979). *But see Petty v. Superior Court*, 116 Cal. App.2d 20, 253 P.2d 28 (2d Dist. 1953) (joint representation waives attorney-client privilege).

²¹³ See ABA INFORMAL OPINION 564 (1962).

²¹⁴ See generally R. ROTUNDA, LAW, LAWYERS AND MANAGERS—THE ETHICS OF CORPORATE CONDUCT 129-34 (1977); Marsh, *Relations With Management and Individual Financial Interests*, 33 BUS. LAW. 1227 (1978). A cogent analysis of squeeze outs and litigation arising from protracted policy disagreements and dissention among shareholders in closely held corporations is contained in H. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS (1975).

²¹⁵ See notes 144-45 and accompanying text *supra*.

²¹⁶ ABA INFORMAL OPINION 1056 (1968). If the attorney does represent the current management and the takeover is successful, he or she may feel compelled to resign as general counsel even if not asked to do so because of the

trol of the business engage in illegal or fraudulent activities, however, as would be the case where majority shareholders attempt an improper squeeze out of a minority shareholder, then general counsel for the business would, as was pointed out in the last section,²¹⁷ have to take appropriate action, including possibly resignation as general counsel, in order to forestall such action.

Split ups and spin-offs present particularly difficult problems. The general counsel can properly continue to represent the original entity, except with respect to serious disputes involving the former investors. Alternatively, he or she could represent any new business formed by one or more of the former owners with similar disqualification in disputes arising out of legal matters handled by the attorney's firm before the split. The lawyer, however, must completely sever all ties with the former client, if this alternative is chosen.

These limitations are critical. In *In re Banks*,²¹⁸ for example, two members of a law firm, who acted as general counsel for a family corporation, were publicly reprimanded for their representation of the corporation in several matters following the founder's ouster. In one case, the firm represented the corporation in a contract dispute over the founder's employment rights where the contract in question had been drafted by one of the lawyers. The firm had also represented the corporation in an action brought by the founder's wife partially based on legal issues on which the attorneys had given legal advice. In addition, the firm represented the corporation's purchasers in litigation with the founder. Moreover, after ceasing to represent the corporation, the firm represented former minority shareholders in a spin-off company. They also advised the competitor's shareholders on rights under contracts containing non-competition clauses which they had drafted while counsel for the original corporation. Finally, one of the lawyers remained as a trustee of the original corporation's pension and profit sharing trust subsequent to his firm's representation of the spin-off competitor. This case is not atypical of the types of awkward situations a lawyer is likely to face when a small business client becomes embroiled in disputes among its owners. The wise lawyer will adopt

awkwardness of the situation.

²¹⁷ See Section II (D) (5) and accompanying text, *supra*.

²¹⁸ 283 Or. 459, 584 P.2d 284 (1978).

a liberal policy of total withdrawal when faced with the legal fallout from these disputes.

Transactions between two existing business clients can also present difficult conflicts issues. What starts to be a simple business transaction in which both parties appear to agree on all issues often ends up in litigation with the lawyer caught in the middle. In one recent case,²¹⁹ a lawyer was held liable for malpractice and attorney's fees to both the buyer and the sellers of a financially troubled business. All the participants had been clients of the unfortunate attorney at the time the sale was negotiated.²²⁰ If there is any substantial likelihood that a conflict might arise, a lawyer in this situation should insist that both clients obtain other counsel to handle the transaction. If the dual representation is undertaken and an actual conflict develops, then, of course, the lawyer would have to insist that each of the clients then obtain independent counsel.²²¹

IV. PREVENTIVE ACTION TO MINIMIZE THE RISKS OF LIABILITY FOR INCOMPETENCE

In counseling situations lawyers are increasingly being judged by the standard of an attorney proficient in the area of legal advice sought.²²² This rule is incorporated into Proposed Model Rule 1.1:

A lawyer shall undertake representation in matters in which the lawyer can act with adequate competence. Adequate competence includes the specific legal knowledge, skill, efficiency, thoroughness, and preparation employed in acceptable practice by lawyers undertaking similar matters.²²³

This standard's application to general practitioners representing small businesses can create a variety of serious malpractice and disciplinary risks. There are, however, several ways to minimize these risks.²²⁴

²¹⁹ Hill v. Okay Constr. Co., 252 N.W.2d 107 (Minn. 1977).

²²⁰ The attorney was held liable to the seller of the business because he failed to document the transaction properly and to the buyers because he failed to take appropriate action to protect the buyers against claims by the seller's creditors. *Id.* at 214-219.

²²¹ See notes 197 and 209-212 and accompanying text, *supra*.

²²² See section II *supra*.

²²³ PROPOSED MODEL RULE 1.1.

²²⁴ See generally Cutler, *The Role of the Private Law Firm*, 33 BUS. LAW. 1549 (1978); Mallen & Levit §§ 11-27; Stern & Martin, *Mitigating the Risk of*

First, the lawyer can advise the small business client to retain or associate a more experienced lawyer. This duty to consult is already incorporated into the CPR.²²⁵ Fear of losing a client does not alter the duty or lessen the liability for failure to refer when the matter is beyond the lawyer's competence. In any event, there is nothing improper in suggesting that the client associate a firm that limits its practice to the legal problems in question, or, assuming there is no increased burden on the client, in recommending a lawyer or law firm in another community. Lawyers practicing in less populated areas commonly have a regular working relationship with one or more firms in metropolitan areas.²²⁶

Second, the lawyer, with the client's advance informed consent, can limit the scope of the engagement.²²⁷ The lawyer may restrict the representation to areas in which he or she has the necessary expertise to competently advise the client. In addition, all written opinions by lawyers should include a statement delineating the sources relied on and any limitations on the scope or use of the opinion.²²⁸ In the absence of any restrictions, courts and disciplinary agencies will interpret the scope of the representation in accordance with the client's reasonable expectations.²²⁹

Since the protection afforded by a limited engagement is dependent upon the client's informed consent, the lawyer should

Becoming a Defendant In A Malpractice Action by Your Former Client, 41 TEX. B.J. 525 (1978). See also Cornell, *The Code and the Law Firm*, 63 A.B.A.J. 570 (1977) (law firm policy guidelines for non-legal personnel); Cornell, *Ethical Guidelines for Tax Practice*, 28 TAX LAW. 1, 33-36 (1972) (policy guidelines for tax matters).

²²⁵ DR 6-101(A)(1).

²²⁶ Many lawyers also regularly use firms in Washington, D.C. to assist their clients with federal agencies.

²²⁷ Proposed Model Rule 1.5(c) provides:

A lawyer may limit the nature and purposes of the representation provided to a client if:

- (1) the client's interests will not be materially impaired by the limitation; and
- (2) the limitation is adequately disclosed to the client before the representation is undertaken.

A lawyer may not, however, limit his liability for negligently performing the services he agrees to undertake. DR 6-102(A).

²²⁸ See note 129 and accompanying text *supra*.

²²⁹ See notes 81-84 and accompanying text *supra*.

carefully draft and review the engagement letter with the client. Where a written engagement letter on each matter handled for a client is impracticable, as it often will be in a continuing relationship with a small business client, the lawyer must carefully explain any limitations on the representation, and, whenever possible, make and keep a summary of all conferences with the client regarding such limitations.²³⁰ In any dispute over the scope of the engagement, the burden of proving any limitations will be on the lawyer.

Third, with disclosure of the attorney's lack of proficiency and permission from the client, an attorney may attempt to gain the necessary expertise to handle the matter competently through self-study or attendance at continuing legal education seminars. If this course of action is chosen, the legal fee charged for the representation must account for the attorney's initial lack of expertise, but in no event should it be greater than a reasonable fee charged by a lawyer proficient in the field for the same work.²³¹

Fourth, self-discipline and an efficient docket control and diary system can significantly reduce the number of claims against lawyers based on failure to complete legal tasks in a timely manner. While most lawyers probably have a litigation docket control system, the growing number of non-litigation neglect cases indicates that a significant number of lawyers do not have an

²³⁰ Although there is no specific requirement that engagement letters be in writing, Rule 1.6 of the Proposed Model Rules requires that the basis of the fee "shall be put in writing before the lawyer has rendered substantial services in the matter unless the services are similar to those previously rendered to the client or are performed in an emergency situation." This rule will undoubtedly "encourage" lawyers to use engagement letters that cover other matters as well as fees.

²³¹ See note 78 *supra*. In this connection, one commentator has offered this sage advice:

The lawyer should always be mindful of the value of the undertaking to the client in relation to the cost of rendering the legal services requested. DR 6-101(A)(2) should not require the lawyer to make the actual cost of the undertaking out of proportion to its value to the client. Within this framework, the lawyer must undertake reasonable legal research to ascertain the law and reasonable investigation to ascertain the facts so that the client may be properly advised or that an informed decision as to a course of action based upon an intelligent assessment of the problem can be made." Gaudineer, *Ethics and Malpractice*, 26 *DRAKE L. REV.* 88, 114 (1976).

adequate control system for non-litigation matters. Several docket control systems are commercially available.²³²

Fifth, internal review procedures for all work are essential. The review should be made by someone other than the lawyer who prepared the documents. This is, of course, impossible in a one person law firm, but by following a rule that no important opinion or other document can be sent out until two or three days after the final draft is typed and after it has been reviewed one last time by the draftsman, the same basic result can be achieved.

Sixth, each file should be assigned to two lawyers. Whenever possible, at least one of them should be a partner. The old adage that two heads are better than one applies here. The assignment of two lawyers to each file increases the possibility that important issues will not be overlooked and that inadvertent errors will be discovered before they prejudice the client's rights.

Finally, lawyers too often fail to understand the principle of client autonomy. Competence, in the sense of adequate preparation, skill and promptness is not enough. The client is the ultimate decision maker. Part of the lawyer's duty of competence is to make sure the client has all the relevant legal, factual and other information needed to make an informed decision.²³³

Competence also requires that a lawyer be in a position to render independent, objective and impartial advice to clients. Conflicts of interest cannot be altogether eliminated. Nevertheless, sensitivity to the problems that can arise when client conflicts exist and the adoption of sensible policies for dealing with conflict issues when they do arise will minimize the risk of prejudice to the client. It will also avoid the embarrassment, ill feelings, and possible disciplinary and malpractice sanctions that can result from having failed to handle a conflict situation properly.

In order to effectively monitor disqualifying conflicts of interest, a law firm must have an established procedure for reviewing all new clients and new matters for potential conflicts.²³⁴ The

²³² For further information on docket control systems see M. ALTMAN & R. WEIL, *HOW TO MANAGE YOUR LAW OFFICE* §§ 10.02, 10.15 (1973); 1 *LAW OFFICE ECONOMICS AND MANAGEMENT MANUAL* § 32 (1970); Orren, *Filing, Docket Control and Information Retrieval* *THE LAWYER'S HANDBOOK* § C (Rev. ed. 1975).

²³³ See Section II(D)(1-4), *supra*.

²³⁴ Most conflict of interest issues can be discovered by careful analysis prior

responsibility for overseeing this procedure and determining whether, and under what conditions, representation should be taken must be under the jurisdiction of one or more senior partners. In order to have a workable system, the firm should have a new matter indexing system that includes an index of all clients, cases and major issues. Each new file should also be cross-checked against similar indexes maintained on all closed files.²³⁵ A conflicts check must be made in every new file opened by the firm without exception, whether the file involves litigation, counseling, or *pro bono* work. It is also sound practice to circulate on a regular basis the list of all new matters to every member of the law firm. This procedure may well uncover conflicts missed by the indexing check and the senior partner review. Finally, a firm should consistently apply the rule in Ethical Consideration 5-15 which admonishes lawyers to resolve all doubts against the propriety of representation.

Law firm conflicts policies should also address the circumstances under which a member of the firm can be a director or officer or can make an investment in a client. Rules describing the proper manner of advising clients of existing or potential conflicts and delineating the circumstances in which the firm will withdraw from representation are also necessary. Conflict problems arising from multiple representation situations are particularly acute in a small business practice because general counsel for the business also commonly represents one or more of the principal investors. In these situations, even though the initial acceptance of the representation may be proper, the question of continuing the dual representation must be reviewed constantly.

CONCLUSION

The suggestions made in the last section apply to legal counseling of any kind, and not just to counseling of small business clients. Perhaps the only unusual features about representing

to making the initial decision to undertake the representation. Occasionally, however, an unforeseeable conflict will arise after the representation is accepted. This occurs, for example, when two clients that are represented by the firm in unrelated matters subsequently become involved in a controversy. The firm will probably be disqualified from representing either client in this situation. See notes 165-67, 188, 209-12 and accompanying text *supra*.

²³⁵ See the materials cited in note 231 *supra*.

small businesses are the increasing complexity and breadth of the legal problems their legal counsel are requested to resolve and the large number of situations in which awkward conflict of interest issues exist. No lawyer can be a specialist in every field of law or totally avoid client conflicts. If that were required, no practitioner could represent a small business competently. Competence does not, however, demand that a lawyer have the expertise of a specialist at the time the representation is undertaken. Another lawyer with the necessary expertise can always be associated or the lawyer can acquire the necessary knowledge. In addition, a lawyer can limit the scope of the representation. A competent lawyer must also apply, with reasonable promptness, the relevant law and facts skillfully, and disclose the factors necessary for the client to make an informed decision on what course of action to pursue. Finally, a competent lawyer must be sensitive to conflicts of interest that may impair his or her ability to render objective, impartial advice to the client and must be willing voluntarily to withdraw from the representation when a disqualifying conflict exists. That, it seems to me, is not too much to ask of any lawyer.