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THE ETHICAL IPO LAWYER

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I. INTRODUCTION

The following case study considers various ethical issues that confront a transactional lawyer, some of which are common to all lawyers across all practices and others of which are unique to transactional lawyers. In Part I we consider — through a hypothetical new engagement — how a seemingly benign and simple new proposed representation can trigger a complex series of waiver and disclosure obligations under California's Rules of Professional Conduct. Following the discussion of the various conflicts, we address ethical issues that arise from electronic communications (Part III) and, in the final part, we address the (potentially conflicting) duties that an attorney may confront if she discovers that a public client may have violated the law (Part IV). By no means does this article purport to be an exhaustive analysis of all possible consequences and potential solutions, rather it is simply meant to exemplify the complexity of what could easily be real life circumstances facing a law practitioner in California.

Our heroine in this saga is Dorothy Gale, a partner at Lions, Tigers & Bears LLP ("LTB"). She focuses her practice on business, corporate and securities laws. She has represented a private company for several years, but when the company — let's call it Flying Monkeys — decides to undertake an initial public offering, it engages a major Emerald City firm to represent it in connection with the IPO, while Gale and LTB continue to perform various miscellaneous services for the company. Another law firm represents several investment banks underwriting Flying Monkeys' IPO. With the IPO preparations underway, the company and the underwriters decide to permit some of the company's existing investors to participate in the IPO as selling shareholders, side by side with the company. Because the selling shareholders will be required to deliver certain documents and legal opinions to the underwriters in connection with the IPO, the company inquires if Gale would be willing to represent some or all of the selling shareholders in the transaction, and the company even offers to pay their legal fees, in part because it is contractually obligated to do so for some of the selling shareholders. Gale eagerly expresses her willingness, but informs the company that she has to run appropriate conflicts checks first. The next morning, the 400-page door-stopper of a conflict check arrives on Gale's desk. Several double lattes later, Gale determines the following issues must be addressed:

1. LTB will be representing more than one client in connection with the IPO.
2. LTB currently represents an affiliate of the underwriters of the IPO in an unrelated matter.
3. LTB continues to represent Flying Monkeys on corporate matters and, as a result, has potentially material confidential information.
4. LTB is currently representing another existing client adverse to one of the selling shareholders in a separate, unrelated matter.
5. LTB has also been engaged by, and currently represents, several of the selling shareholders or their affiliated entities in matters unrelated to either the company or the IPO.
6. LTB has an affiliated investment fund for the benefit of the firm's partners, and the fund had made an investment in the company during one of its prior rounds of financing and would be selling the stock in the IPO along with the other selling shareholders.

II. JOINT CLIENT REPRESENTATION; PAYMENT OF FEES

A. Conflict of Interest

Even before she cracks open that conflicts report, Gale knows she has one ethical issue to address: joint representation. Any time a lawyer represents more than one client (entity or individual) in a matter, she must obtain the informed written consent of all clients.[1] The California Rules of Professional Conduct state that the attorney must obtain the informed written consent of each client whenever the clients' interests are, or could potentially become, adverse. Theoretically that means that one might not need a waiver if there are no potential conflicts. Because the future is unknown, as a practical matter, the rule requires consent for every proposed joint representation arrangement.

In order for the client's waiver of the conflict to be considered effective it must be "informed," — that is, the lawyer must have disclosed to the client the reasonably foreseeable consequences of agreeing to the joint representation before obtaining the client's consent.[2] Be as specific as possible. If there are actual conflicts, these should be

1. Rule 3-310 (C)(1) and (2).
2. Rule 3-310(A)(1).

explained fully and completely, including the reasonably foreseeable consequences that could occur. Note, also, that the client consent must be in writing. "We talked about it on the phone and the client agreed," will not cut it if the client later objects, resists paying fees or sues for breach of duty.

In this case, after considering the matter, Gale concludes that there are no actual conflicts. Her conflict waiver letter, therefore, will focus on potential conflicts. Gale recognizes that a conflict could arise among the selling shareholders if the company or the underwriters were required (as a result of market conditions, size of the offering or other transaction marketing reasons) to reduce the number of shares the selling shareholders were permitted to sell in the offering. If that cutback was applied unevenly among the joint clients, for example, because some of the selling shareholders had contractually established rights to participate at some higher percentage, disputes could arise between the selling shareholders about how the cutback is calculated and applied. If such a dispute were to arise, Gale could not represent any of the selling shareholders adverse to each other. Thus, Gale warns the selling shareholders that they would be required to obtain separate counsel to resolve such an intercine dispute.

Sometimes a joint representation may involve one client who has been a firm client for years and another client for whom the representation is much more limited. In that situation, the attorney might want the joint clients to agree in advance that if a conflict arises the lawyer will continue to represent the long time client, X, and the other client, Y, waives any right to disqualify the attorney, even if the attorney wants to represent X adverse Y. Courts have upheld such advanced waivers when the evidence shows that the attorney explained the consequences of the waiver to the client and the client gave his or her consent knowingly.[3] That is why it's so important to be specific about any particular conflicts.

Gale's waiver letter to the joint client will also touch on other reasonably foreseeable consequences of joint representation. An important one — and certainly one that a law firm wants to make sure all the joint clients understand — is that under California law, there is no attorney-client privilege between joint clients. Thus, if two joint clients get into a dispute down the road, what either one said to

3. *Zador Corp. v. Zwan*, 35 Cal. App. 4th 128T, 1289-90 (1995)

their joint attorney will be admissible in court.[4] Other risks of joint representation include the risk that the clients may have different goals or they might disagree about the strategy the attorney should follow. As noted above, the waiver letter should let the clients know that, while such conflicts may never materialize, if such a conflict did arise, the attorney might not be able to continue representing all clients.

While the attorney should clearly lay out all known or potential conflicts, the waiver letter does not need to be a parade of horribles: there are many benefits to joint representation, and a lawyer should not hesitate to lay those out as well in the waiver letter. For the most part, clients are pleased to be part of a joint representation in appropriate situations, such as this one, because of the significant cost savings. In many circumstances, joint representation also creates the appearance of a united front, which can have strategic advantages.

There is another waiver that Gale must obtain from the selling shareholders. Flying Monkeys agreed to be responsible for the legal fees of the selling shareholders. California's ethics rules require Gale to obtain the informed written consent of the selling shareholders that another party, Flying Monkeys, can pay their legal fees. This is usually the least difficult conflict waiver to obtain — who doesn't want to have someone else pay their legal fees. But in all seriousness, the rule derives from a concern that when another party is paying the client's fees, it may interfere with the lawyer's duty to the client. Of course, if the paying party is a joint client, the lawyer owes a duty of loyalty to that client as well. But here, Flying Monkeys is not a client for purposes of the IPO, so the law firm's duty of loyalty runs only to the selling shareholders. Another concern a client may have about the fee arrangement is that the lawyer may share its confidential information with the paying party. Without the client's agreement, the lawyer cannot do that.[5]

What if some of the prospective clients are entities? Who can give consent on behalf of an entity? The answer often can be found in the entities' organizational documents and the ethics rules. Under Rule 3-600 of the California Rules of Professional Conduct, consent to joint representation may be given "by an appropriate constituent." The attorney would want to consult the entity's organizational documents to determine who is the appropriate constituent. But there is an

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4. California Evid. C. §951
5. Rule 3-310 (F).

important caveat: if the proposed joint representation will involve shared representation between an entity and one or more of its managers or other constituents, the individuals who will be part of the joint representation may *not* consent on behalf of the entity. To put this in more concrete terms, if a lawyer is jointly representing a corporation and the CEO, the CEO cannot consent to the joint representation on behalf of the corporation. This issue arises most commonly in shareholder litigation where many officers and directors are named as defendants and it can be challenging to identify an appropriate constituent to consent to a joint representation.

While we are on the topic of representing entities, let us mention another ethical concern that should be on the lawyer's mind — remembering who is the client. "In representing an organization, a member shall conform his or her representation to the concept that the client is the organization itself, acting through its highest authorized officer, employee, body, or constituent overseeing the particular engagement."[6] Whenever you are talking to an individual officer, owner or other representative of an entity, it is very important to make sure that this person understands that you are not representing him or her personally, but rather will be representing the entity, and every bit of advice that you are going to discuss will be given on behalf of, and with the best interests of, the entity in mind. This means that when it comes to the matters that impact such individual representative personally, if any such matters exist, (for example, with respect to how the proceeds from the sale of stock would be divided among the entity's owners), it is important to remind the representative that he or she cannot rely on you for advice about how this impacts them personally and should seek independent counsel advice with respect to any questions they may have in that regard.

In sum, Gale will need to obtain the informed written consent of each client in the joint representation both to the fact that each client will be represented jointly and to having their fees paid by Flying Monkey. Typically, a law firm would include all of the foregoing disclosures in the initial engagement letter that each member of the group would be asked to sign. It would also be prudent to inform the clients in advance that the firm may withdraw as counsel if its fees and costs are not paid as agreed.

6. Rule 3-600 (A).

B. Current Client Conflicts: The Duty of Loyalty

Having drafted the joint clients waiver, Gale turns to conflicts between other clients that LTB either is or has represented. The conflict check unearthed the fact that one of Gale's colleagues represents an affiliate of one of the underwriters in a matter unrelated to Flying Monkeys or its IPO. The selling shareholders are deemed adverse to the underwriters in the IPO matter. Assume for the moment that LTB represents the underwriter itself rather than an affiliate. In that scenario, LTB would need the underwriter's consent before it could take on the representation of the selling shareholders adverse to the underwriter.[7] That is because California law prohibits an attorney from representing a client and at the same time being adverse to that client on any matter without the client's informed written consent. The prohibition applies even where the matters on which the attorney represents the two clients have nothing in common. The interest at stake in such a conflict is the attorney's duty of loyalty (as opposed to the duty of confidentiality). Because the conflict is considered to be so grave, the rule for disqualification of an attorney who acts adversely to one of his current clients without its consent is more stringent than the rule used when an attorney wants to be adverse to a *former* client. When an attorney acts adversely to a current client without its consent, disqualification is *per se* and automatic. Furthermore, the fact that Gale herself does not represent the underwriter makes no difference. Such conflicts are imputed to all members of the same firm.[8]

However, here LTB does not represent the underwriter but an affiliated entity. It is possible that this affiliate is sufficiently distinct and unrelated to the underwriter, such that they would not be considered to be one and the same for the purposes of the attorney-client relationship with LTB. Unfortunately, the analysis of the relationship between affiliated entities is complex and heavily fact-dependent.[9] Although there is a paucity of case law on this subject, the California decision in *Morrison Knudsen* is generally cited as the authority for establishing some of the factors that must be considered in the analysis, mainly focusing on the existence of unity of interests

7. *Flatt v. Superior Court*, 9 Cal. 4th 275, 284 (1994).
8. *City and County of San Francisco v. Cobra Solutions, Inc.* 38 Cal. 4th.
9. See ABA Formal Ethics Opinion 95-390; CA State Bar Opinion 1989-113; Morrison Knudsen Corp. v. Hancock, Rothert & Bunshoft, LLP, 69 Cal. App. 4th 223.

between the entities, the overlap in their respective operations, management and control over legal affairs and, most importantly, the attorney's access to substantially related confidential information. The *Morrison Knudsen* court summarized the conflicts analysis as follows: "The principal focus should be the practical consequences of the attorney's relationship with the corporate family. If that relationship may give the attorney a significant practical advantage in a case against an affiliate, then the attorney can be disqualified from taking the case."[10]

In applying *Morrison Knudsen* in disqualification proceedings, however, different courts have assigned different weight to some of these factors, either applying the totality of circumstances approach or looking to the existence of strong evidence of any one or two of the factors in making the determination that the affiliated entities would or would not be deemed the same client for the purposes of the attorney-client relationship. For example, if an attorney received confidential information in the course of representing one client, and that information was substantially related to a matter in which the attorney would be adverse to an affiliate of that client, that fact alone may be dispositive in the determination that a conflict exists, and the attorney would not be permitted to pursue the representation without a waiver. Fortunately for LTB, the affiliated entity of the underwriter that it represents turned out to be an entirely distinct and independent company with separate management, legal departments and geographic locations, and the firm did not receive any confidential information through that representation having any relationship to the representation of the selling shareholders in the IPO. Accordingly, LTB concluded that its existing representation of the affiliate did not require the firm to obtain a waiver of conflicts in order to take on the representation adverse to the underwriters in the IPO.

C. Former and Current Client Conflicts: Duty of Confidentiality

Gale continues to represent Flying Monkeys on corporate matters, although she will be adverse to Flying Monkeys in her representation of the selling shareholders. Gale therefore will need Flying Monkeys' consent to be adverse to it as a current client. There is a second

10. Morrison Knudsen, 69 Cal. App. 4th 223, 253.

additional reason that Gale needs Flying Monkeys' consent: Gale may have confidential information about Flying Monkeys that is material to her representation of the selling shareholders. A lawyer must obtain the informed written consent to represent a new client where, as a result of the representation, the attorney has obtained confidential information material to the new employment.[11] This rule, unlike the rule discussed in the preceding section, applies equally to current and former clients. Thus, the fact that an attorney no longer represents a client does not resolve the conflict if the attorney acquired confidential information that would be material to a new proposed engagement. On occasion, courts permit a law firm to avoid disqualification by protecting a client's confidential information with the use of screening mechanisms.[12] This is a new development in California law so its parameters are not well defined. In any event, screening is not an option in Gale's case since the same lawyer will be representing the new clients and has confidential material information about the existing client.

Gale's representation of the selling shareholders thus implicates both her duty of loyalty to Flying Monkeys (because it is a current client and she will be at least technically adverse to it on behalf of the selling shareholders) and the duty of confidentiality (because she possesses confidential material information of Flying Monkeys). Accordingly, she needs Flying Monkeys' consent to take on the representation of the selling shareholders. Because Flying Monkeys asked Gale to take on the selling shareholders, getting its consent should be a simple matter. However, there are some complexities to the arrangement Flying Monkeys has proposed that merit careful consideration.

As a result of her long-standing representation of Flying Monkeys, Gale has learned confidential information about the company. The ethics rules do not allow her to disclose that information to the selling shareholders. Indeed, California has a very strict rule requiring attorneys to "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets of his or her client."[13] It would be prudent for Gale to make it clear to the selling shareholders in writing

11. 3-310(E).
12. *Kirk v. First American Title Insurance Co.*, 183 Cal. App 4th 776 (2010)
13. Business and Professions Code §6068(e); Rule 3-100(A)

that she will not disclose confidential information that she has received from Flying Monkeys.

However, Gale's duty of confidentiality to Flying Monkeys could create some tension with her obligation to keep her other clients — the selling shareholders — informed of material developments in their case.[14] For example, in its ongoing representation of the company, Gale may discover or receive information from or about Flying Monkeys (whether or not related to the IPO) that in its judgment would represent a significant development impacting the selling shareholders' interests in the IPO. If this occurs, it would be the firm's duty to disclose such information to the selling shareholders. Because this obligation of confidentiality would be in conflict with the duty that Gale would owe to the selling shareholders if she believes that the information represents a significant development impacting the selling shareholders' interests in the IPO, Gale may want to obtain a written consent of Flying Monkeys to the disclosure of such information to the selling shareholders. Flying Monkeys may balk at that proposition. Ultimately, Gale needs to consider whether she will be able to comply with her ethical obligations to both clients if she takes on the selling shareholders.

D. Representation of a Selling Shareholder's Adversary In Separate Matter

The conflict report also revealed that another LTB partner represents Oz Technologies, which is involved in a bitter patent lawsuit with Munchkins LLC, a selling shareholder. Although the IPO has no connection to the patent lawsuit, and LTB will not be adverse to Oz, California's ethical rules prohibit LTB from taking on Munchkins as a client without the informed consent of both Oz and Munchkins.[15] Therefore, LTB must provide appropriate disclosure to and obtain written conflict waivers from its existing client and the proposed new client. Pause here for a moment. LTB represents Oz adverse to Munchkins. Munchkins is well aware that LTB represents its adversary because the litigation is longstanding and contentious. Nonetheless, the ethics rules require LTB to inform Munchkins that it is adverse in the other matter and obtain its consent so that Munchkins won't form

14. Rule 3-500.
15. Rule 3-310 (C)(3).

the impression that, because LTB is now its lawyer, LTB will go easy on it in the patent litigation.

E. Representation of Clients on Unrelated Matters Must Be Disclosed; Confidential Information

In addition to conflicts, which require written waivers, California's ethical rules require attorneys to disclose certain relationships that could impact the attorney's objectivity, loyalty or otherwise interfere with the attorney's representation of the client. These rules require the attorney to disclose legal, business, financial, professional or personal relationship the lawyer has with a party or a witness in the matter.[16] The attorney does *not* need the consent of her clients in this scenario. The theory is that the client "consents" with his feet: that is, if the lawyer makes the appropriate disclosures, the client can evaluate whether the disclosed relationship causes him to have a concern about being represented by that attorney. A practical tip is to make this explicit in your disclosure letter with a gentle phrase like, "I don't believe this relationship will impact my ability to provide you with loyal and zealous representation, but if you have any concerns, please let me know." If a client later claims you were beholden to another interest and failed to represent him as required, the client's silence in the face of your invitation to discuss the matter will be a nice piece of evidence to have.

LTB currently represents Ms. West, a selling shareholder, with respect to her shoe manufacturing business. This work is unrelated to the Flying Monkeys' IPO. LTB thus has a legal relationship with Ms. West that it must disclose to the rest of the selling shareholders, who might be concerned that Gale will favor Ms. West because she is a major client. LTB does not need to obtain the consent of the joint clients.[17] These disclosure obligations apply to former as well as current relationships. In other words, if Ms. West were a former client, Gale would still need to disclose that relationship to the selling shareholders. The ethical rules require an attorney to disclose his or her relationships. There is no requirement for the attorney to research her colleagues' relationships. Indeed, as a matter of simple logic, if a lawyer does not know, for example, that the adversary's CEO is

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16. Rule 3-310 (B)(1).
17. 3-310 (B)(1)

related to one of her partners, her loyalty to her client cannot possibly be impaired by that relationship of which she is blissfully unaware. On the other hand, this is not an invitation to put blinders on. If an attorney knows about a relationship between a colleague and a witness or party, she should disclose it.

F. Firm's Ownership of Stock

If a firm, or an individual attorney, takes an equity stake in the client company, then in any subsequent work that affects the value of that equity, the firm (or the attorney) will be required to provide the client with a written disclosure about this financial interest. LTB, through its affiliated investment fund, holds equity in the Flying Monkeys and intends to sell its stake in the IPO. Therefore, the firm has financial interest in the subject matter of the representation and is required to disclose this interest to the selling shareholders.[18] On the other hand, because LTB is not representing Flying Monkeys in connection with its IPO, it is not required to make any additional written disclosure of this financial interest to Flying Monkeys, even though the firm intends to participate, through its investment fund, in the IPO. Of course, as a diligent and careful law firm, LTB took care to obtain Flying Monkeys' written consent before its initial investment because the California Rules of Professional Conduct state that "A member shall not enter into a business transaction with a client; or knowingly acquire an ownership .... interest ..., unless each of the following requirements has been satisfied:

(a) The transaction and its terms are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which should reasonably have been understood by the client; and

(b) The client is advised in writing that the client may seek the advice of an independent lawyer of the client's choice and is given a reasonable opportunity to seek that advice; and

(c) The client thereafter consents in writing to the terms of the transaction or the terms of the acquisition."[19]

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18. Rule 3-310 (B)(4).
19. Rule 3-300.

The consequences of failing to comply with the ethical rules concerning doing business with a client can be very harsh. Failure to comply with the rule renders the transaction voidable at the client's option, and may also result in denial of any compensation for the attorney's services.[20]

III. COMMUNICATIONS WITH CLIENTS AND OTHERS

Once all engagement letters and conflict waivers are finally signed, LTB can finally turn to the subject matter of its representation, and there is a lot that needs to be explained to the selling shareholders, and there are several documents that will need to be reviewed and signed by the selling shareholders. Given that scheduling conflicts, location and time zone differences get in the way of in-person meetings, much of the communications would take place via electronic mail, as is typical of most transactions these days — how did we live without email, just a few short years ago?!

The California Rules of Professional Conduct state that "A member shall keep a client reasonably informed about significant developments relating to the employment or representation, including promptly complying with reasonable requests for information and copies of significant documents when necessary to keep the client so informed."[21] But how much information can an attorney communicate to the client via email? What if there is a need to send a very confidential attachment? What if the attorney receives somebody else's information via email that appears very sensitive?

As noted above, attorneys in California are required to protect their clients' confidential information. The California Rules of Professional Conduct state that "A member shall not reveal information protected from disclosure by Business and Professions Code section 6068, subdivision (e)(1) without the informed consent of the client, or . . . to the extent that the member reasonably believes the disclosure is necessary to prevent a criminal act that the member reasonably believes is likely to result in the death of, or substantial bodily harm to, an individual."[22] Unlike the American Bar Association rules, California does not allow disclosure of

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20. *Fair v. Bakhiatri,* 195 Cal. App. 4th 1135 (2011).
21. Rule 3-500.
22. Rule 3-100.

confidential client information to prevent financial harm to a business or an individual.

In general, using email will not violate the obligations of confidentiality owed to the client, nor will it trigger a waiver of attorney-client privilege with respect to otherwise privileged communications.[23] However, email communications are fraught with potential risks due, in part, to their expedient nature. For example, accidental auto-filling of an unintended recipient's name in the "To" field or a careless "Reply All" email response represent just some of the potential problems with email communications. An off-the-cuff quick reply to a client's email question may also defeat a possible judgmental immunity defense in a later malpractice claim if the attorney was not able to show that he or she exercised appropriate care in researching, investigating and considering the issues presented by the question before hastily responding.[24] In addition, when communicating with a client by email, one must consider whether messages are being received at the client's place of employment, and how that may impact attorney confidentiality obligations and privilege matters, since the employer is likely to own the computer and the means of communications that are being used and will often have a policy that employees should have no expectations of privacy while using those systems at work.[25] Some courts have suggested that an employee logging into a personal, password-protected email account at work, rather than using her work email, would have a higher expectation of privacy than simply using work email, but this issue has not been definitively decided in many states.[26]

Finally, when sending documents as attachments to an email, it is the attorney's responsibility to protect any confidential information electronically embedded in those documents.[27] That information is called "metadata" and it contains drafting and transmission history of the document, comments on prior drafts and even the names of those who

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23. ABA Formal Opinion 99-413. CA Evidence Code §917(b). See also In re Asia Global Crossing, Ltd. (SDNY 2005) 322 B.R. 247, 256.
24. See, for example, Village Nurseries, LP v. Greenbaum (2002) 101 Cal. App. 4th 26, 37 (citing Smith v. Lewis (1975) 13 Cal. 3rd 349, 359).
25. See In re Asia Global Crossing, Ltd. 322 B.R. 247, 257-258 (SDNY 2005); Holmes v. Petrovich Development Co. 191 Cal. App 4th 1047 (2011)
26. See Stengart v. Loving Care Agency, Inc. 990 A.2d 650, 663 (-2010).
27. See, for example, CA State Bar Formal Opinion No. 2007-174.

worked on the document. Most law firms have special software programs designed to scrub the metadata prior to the email being sent. And on the receiving end, it may be unethical for a lawyer to review or search the metadata that appears to have not been removed inadvertently, though there is a split of opinions on this issue among different states.

The California Rules of Professional Conduct state that "While representing a client, a member shall not communicate directly or indirectly about the subject of the representation with a party the member knows to be represented by another lawyer in the matter, unless the member has the consent of the other lawyer."[28] Oddly enough, even though law firm "A" continues to represent Flying Monkeys in many matters, it does not represent the company in connection with its IPO, and therefore, it is likely necessary for law firm "A" to obtain the consent of law firm "B" in order to communicate directly with Flying Monkeys in connection with the IPO.

IV. VIOLATIONS OF LAW: DISCOVERY, PROCESS AND ADVICE

What happens if one of the selling shareholders is insisting on withholding some information from the IPO-related documents that the attorney believes would represent a material omission for the purposes of Flying Monkeys' disclosures being made in the IPO-related registration statement and, therefore, would result in a violation of Sections 11 and 12 of the Securities Act of 1933, as amended?

A. California Rules

The California Rules of Professional Conduct state that "A member shall not advise the violation of any law, rule, or ruling of a tribunal unless the member believes in good faith that such law, rule, or ruling is invalid. A member may take appropriate steps in good faith to test the validity of any law, rule, or ruling of a tribunal."[29] For example, even if a violation already occurred, a lawyer could not negotiate a return of stolen property on behalf of a client in exchange for an agreement by the victim not to report the crime.[30]

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28. Rule 2-100.
29. Rule 3-210.
30. See People v. Pic'l 31 Cal.3d 731 (1982).

But what happens if you discover something that your client is doing that you believe to be illegal? As noted above, unless you are trying to prevent a criminal act that you reasonably believe is likely to result in the death of, or substantial bodily harm to, an individual, under the California Rules of Professional Conduct, you are not permitted to disclose the client's confidential information without the client's consent.

The California Rules of Professional Conduct state that ". . . (B) If a member acting on behalf of an organization knows that an actual or apparent agent of the organization acts or intends or refuses to act in a manner that is or may be a violation of law reasonably imputable to the organization, or in a manner which is likely to result in substantial injury to the organization, the member shall not violate his or her duty of protecting all confidential information as provided in Business and Professions Code section 6068, subdivision (e). Subject to Business and Professions Code section 6068, subdivision (e), the member may take such actions as appear to the member to be in the best lawful interest of the organization. Such actions may include, among others:

(1) Urging reconsideration of the matter while explaining its likely consequences to the organization; or

(2) Referring the matter to the next higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest internal authority that can act on behalf of the organization.

(C) If, despite the member's actions 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 a violation of law and is likely to result in substantial injury to the organization, the member's response is limited to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700."[31] This means that if the selling shareholder in question continues to insist on withholding the information, law firm "A" would be required to keep that information confidential and would most likely reach the conclusion that it may no longer represent that particular selling shareholder.

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31. Rule 3-600 (B) and (C). See also, Rule 3-700 (B) and (C).

B. Sarbanes-Oxley Act and SEC Rules

With the advent of the Sarbanes-Oxley Act of 2002, in the wake of financial scandals of Enron and WorldCom, the SEC was mandated to and adopted its own rules governing attorney conduct in connection with reporting violations of law committed by publicly reporting companies.[32]

Those rules: (1) require attorneys appearing and practicing before the SEC to report evidence of a material violation of the securities laws or breach of fiduciary duty to the issuer's chief legal officer and, in some cases, to continue to report up the corporate ladder, up to and including the full board of directors;[33] and (2) permit such attorneys, in certain circumstances, to disclose to the SEC confidential information relating to the representation without consent of the company,[34] this latter part presenting an ethical conundrum for California lawyers. The SEC defines "appearing and practicing before the Commission" very broadly to include:

(i) transacting any business or communications with the SEC;

(ii) representing an issuer in a SEC administrative proceeding, investigation or inquiry; or

(iii) providing advice in respect of the United States securities laws or the SEC rules or regulations regarding any document that the attorney has notice will be filed with or incorporated by reference into any document that will be filed with the SEC, including in the context of preparing any such document or advising whether such document, statement or opinion is required to be filed.[35]

Since there is no requirement for direct interaction with the SEC, a licensing attorney, for example, providing a description of the license agreement for an annual or a quarterly SEC filing, or possibly even simply negotiating the license agreement, if the attorney has notice that it is a material agreement that will be filed with the SEC, may be deemed "appearing and practicing before the Commission" and, therefore, obligated to report "evidence of a material violation" by

32. See 17 CFR Part 205, SEC Release Nos. 33-8185; 34-47276; IC-25919; File No. S7-45-02.
33. SEC Rule 205.3(b)(1).
34. SEC Rule 205.3(d)(2).
35. See SEC Rule 205.2(a).

the company or by any officer, director, employee, or agent of the company to the company's chief legal officer or to both the company's chief legal officer and its chief executive officer. Since law firm "A" is advising selling shareholders in connection with the IPO, including with respect to documents that the firm knows will be filed with SEC as exhibits to the registration statement, it is very likely that law firm "A" would be deemed "appearing and practicing before the Commission" and, therefore, subject to these rules. However, given its obligations of confidentiality to the selling shareholders, law firm "A" is likely to end up in an untenable position of not being able to comply with the SEC rules without violating California Rules of Professional Conduct.

The rules define "material violation" as any "material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law."[36] "Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[37] Upon receiving a report of evidence of a material violation from an attorney, the chief legal officer must conduct an investigation and report back to the attorney that the inquiry either revealed no such violation or that "all reasonable steps to cause the issuer to adopt an appropriate response" are being taken.[38] If the chief legal officer or the chief executive officer does not respond appropriately, or if reporting to them would be "futile" because they are involved in the wrongdoing, it is the attorney's duty to report the violation to the company's audit committee, another committee of independent directors or to the full board of directors. As an alternative to this up-the-ladder reporting, the attorney may report the evidence of a material violation to a "qualified legal compliance committee," or QLCC, if the company established one prior to the reporting event. The QLCC must consist of at least one member of the company's audit committee and two other independent directors, and must establish a written procedure for receiving and addressing any report

36. SEC Rule 205.2(i).
37. SEC Rule 205.2(e).
38. SEC Rule 205.3(b).

of a material violation. The QLCC must have the authority to conduct any investigation and implement appropriate response measures and to take other appropriate actions, including the authority to notify the SEC in the event that the issuer fails in any material respect to implement an appropriate response that the QLCC has recommended the issuer to take.[39] Once the report is made to the QLCC, the attorney's reporting obligations are fulfilled, with no further up-the-ladder reporting requirements.

Supervising and subordinate attorneys are treated differently under the SEC rules, though each has his or her own responsibilities to comply with the reporting obligations. An attorney supervising or directing another attorney who is appearing and practicing before the SEC will be deemed to be appearing and practicing before the SEC as well.[40] A company's chief legal officer is an example of a supervisory attorney. A supervising attorney is responsible for the subordinate attorney's compliance with the rules and is responsible for complying with the reporting requirements when a subordinate attorney has reported to the supervisory attorney evidence of a material violation. A subordinate attorney is one who appears and practices before the SEC under the supervision or direction of another attorney (other than under the direct supervision or direction of the company's chief legal officer) and must independently comply with the rules despite acting at the direction of another attorney.[41] A subordinate attorney fulfills his or her obligations by reporting to the supervising attorney, unless the subordinate attorney reasonably believes that a supervising attorney to whom he or she has reported evidence of a material violation has failed to comply with the rules, in which case he or she may report up-the-ladder as described above. It is important to note that an attorney working under the direct supervision of the company's chief legal officer, such as deputy general counsel, is not considered a subordinate attorney and, therefore, cannot satisfy the requirement of the rules merely by reporting to the chief legal officer.

A violation of these rules would subject the attorney to civil penalties and other remedies for violations of federal securities laws that the SEC has available to it, such as censure or bar from practicing before the SEC. While the rules do not provide for a private cause of

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39. See SEC Rule 205.2(k).
40. See SEC Rule 205.4.
41. See SEC Rule 205.5.

action, the attorney could be subject to disciplinary actions under applicable state ethics rules.[42]

V. CONCLUSION

In conclusion, representing companies and their investors or other constituents can be very rewarding and challenging, but can present complex ethical and conflicts issues because of the intertwined client relationships, as the foregoing case study exemplifies. Further, in adopting its rules governing standards of professional conduct for attorneys, the SEC ventured into the area previously reserved for state law. While its authority to do so is not free from doubt and has not been tested in California courts, in the adopting release, the SEC purports to preempt the state ethics rules to the extent they are in conflict with the SEC rules,[43] including allowing permissive reporting of violations to the SEC without the client's consent and the use of confidential client information in defending the attorney's conduct under the rules.[44] The SEC never adopted the initially proposed "noisy withdrawal" obligation requiring the reporting attorney to withdraw from the representation for "professional considerations" and notify the SEC of such withdrawal, but even short of that obligation, an attorney practicing in California would be well-advised to carefully consider all of the ethics requirements applicable under particular circumstances.

42. See SEC Rules 205.6 and 205.7.
43. See SEC Rule 205.1.
44. See SEC Rule 205.3(d).