

LLC or Inc.?

Entity Selection for a Small or Medium-Sized Business

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Entrepreneurs and other business owners have a variety of choices when it comes to choosing the legal entity through which to implement a new venture. In Colorado, those choices are found in Title 7 of the Colorado Revised Statutes and include:

- Limited partnerships formed under the Colorado Uniform Limited Partnership Act of 1981 (“CULPA”)¹
- Limited partnership associations formed under the Colorado Limited Partnership Association Act (“CLPAA”)²
- General partnerships formed under the Colorado Uniform Partnership Act (“CUPA”)³
- Limited liability companies formed under the Colorado Limited Liability Company Act (“Colorado LLC Act”)⁴
- Business corporations formed under the Colorado Business Corporation Act (“CBCA”)⁵

In choosing among the various entities, there are several frequently asked questions that business owners and investors raise. What type of entity should I choose? What kind of protection do I need to shield my personal assets from the liabilities of the business? Do I need to protect the assets of one segment of the business from the liabilities of another segment of the business? How will I be taxed on the profits of the business? Will I be able to claim the tax benefits of any losses generated by the business?

¹ C.R.S. § 7-62-101, *et seq.* Limited partnerships can no longer be formed under the Colorado Uniform Limited Partnership Law of 1931 (“CULPL”) found at § 7-61-101, *et seq.*

² C.R.S. § 7-63-101, *et seq.*

³ C.R.S. § 7-64-101, *et seq.* General partnerships can no longer be formed under the Colorado Uniform Partnership Law (“CUPL”) found at § 7-60-101, *et seq.*

⁴ C.R.S. § 7-80-101, *et seq.*

⁵ C.R.S. § 7-101-101, *et seq.*

While there is no “one size fits all” answer to these questions, the right answer is usually either a business corporation formed under the CBCA or a limited liability company formed under the Colorado LLC Act.

In reaching the decision as to which is preferable, one must ask a number of additional questions. Who is expected to invest in the entity? How will the entity be capitalized? Will the entity borrow money from its owners or from third parties, such as a bank or other lender? Do the projections anticipate that the entity will be profitable in the near future, or not? Is there a desire for pass through tax treatment or not? The answers to each of these questions could affect the choice of entity.

What Form of Entity is Best for Your New Business?

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Introduction

If you desire to protect your personal assets from creditors, or you desire to minimize the tax consequences to your new business and to yourself as an owner of the business, then the legal entity you choose for your business is very important. You and your advisors must consider many factors to insure that your goals are achieved. An attorney or an accountant may appear smart by quickly stating that a particular business form is suitable for every new business. However, the proper choice of entity cannot be determined until you and your attorney explore several factors, including the purposes for forming the entity together with your desire, if any, for a limited liability and tax savings.

You must also carefully consider the legal requirements and regulations applicable to the business or its industry, the choice of jurisdiction for the new business, and your short-term and long-term goals, including ownership succession or the future potential sale of the business. The ability to sell your ownership interest in a business, the ease of raising capital, the relationship between co-owners, and liability for the business’s tax or legal problems are all dependent upon the choice of entity.

Business owners can be held personally responsible – as opposed to just the business being sued – for liabilities and injuries by anyone who believes they have been harmed in any way by the business. Owners may also be held personally responsible for certain contracts and other agreements entered into on behalf of the business. With proper planning, your personal assets can be protected from those risks and your taxes minimized. Deciding on what entity to use is one of the most important decisions made by the owner of a new business.

This article outlines several types of entities available and some of the more important factors that should be considered when choosing the best form of entity for your new business. This article provides summaries of those factors and should not be relied upon as comprehensive. Each particular circumstance is unique and requires its own independent analysis.

There are numerous types of entities for the new business owner to consider. The options include the sole proprietorship, the general partnership, various types of limited partnerships, a C-corporation, an S-corporation, or a limited liability company.

Sole Proprietorship

An unincorporated, sole-proprietorship is one option for a new business when there is a single owner who is not concerned about limiting the owner's liability for operating the business or his or her taxes in connection with the business. There is no legal separation between the owner and the business. Therefore, the owner is personally liable for all business-related debts, obligations, and judgments obtained against the business.

Formation of the sole proprietorship is easy and inexpensive. No filing with the secretary of state is required to form a sole proprietorship. However, the business may be required to register with certain state and local agencies and obtain applicable licenses and permits. All profits and losses from the business must be reported on the business owner's personal tax return. Sole proprietorships have difficulty raising capital because they cannot sell interests in the business. If the owner sells a partial interest in the business, he or she and the new owner have formed a general partnership.

Given the relatively modest expense in creating an entity recognized by statute that will provide substantial protection for various personal liabilities and may also provide favorable tax treatment for the new business owner, sole proprietorships are generally viewed as an unwise choice. The single business owner who is not intentional in forming an entity with limited liability and favorable tax treatment may unwittingly operate the business as a sole proprietorship with all its attendant risks and disadvantages.

Partnerships

Generally, when two or more people associate to carry on, as co-owners, a business for profit, they have formed a partnership, whether they know it or not. Like a sole proprietorship, no filing with the secretary of state is required to form a general partnership. Again, the business may be required to register with certain state and local agencies and obtain applicable licenses and permits. Partnerships have many benefits, but can increase the risk of personal loss for business owners without proper planning. In a general partnership, all of the partners are personally exposed to the actions of the partnership and the other partners.

It is possible to form a general partnership without intending to do so. General partnerships generally are disfavored these days because each partner in a general partnership has unlimited liability for the obligations of the partnership and the acts of the other partners. If limited liability is desired, another type of entity is more desirable. For income tax purposes, general partnerships are a pass-through entity unless the partnership elects otherwise.

Each state has adopted rules regarding how partnerships operate in their state and most states have several different types of partnerships. Depending on the limited liability and tax goals of the owners, limited partnerships are often preferable to general partnerships.

In many states, a limited liability partnership is a general partnership that has elected for most or all the partners to have their liability limited to the amount of property and money they have contributed to the partnership. A limited partnership is a partnership which has at least one general partner who has unlimited liability for the obligations of the partnership, and at least one limited partner that has liability limited to his or her contribution to the limited partnership. Management of a limited partnership is vested in the general partner and may be governed by a partnership agreement or the applicable state statutes.

To form a limited partnership, the owners or the organizer of the partnership must file the appropriate articles or registration statement with the secretary of state in the state of organization. Limited liability limited partnerships, limited partnership associations, and other types of partnerships may be available depending on the state of organization and may provide unique benefits to the business owner. Limited liability partnerships, limited partnerships, limited liability limited partnerships, and limited partnership associations all are pass-through entities for tax purposes.

Corporations

A corporation is a separate legal entity owned by one or more co-owners, legally referred to as “shareholders” or “stockholders.” A corporation is formed by filing articles of incorporation with the secretary of state in the state of incorporation and paying the appropriate filing fee. Each state requires that certain information be included in the articles of incorporation, although those requirements vary from state to state. Each state also allows the incorporator to add other permissive and discretionary provisions to articles of incorporation which may be very important to the governance of the business and limiting risk.

A corporation is an independent legal entity distinct from its shareholders. The corporation has a legal authority to enter into contracts, own property, litigate disputes, and transact other business consistent with its purposes. A corporation generally is characterized by providing limited liability for its shareholders, perpetual existence independent from its shareholders, transferability of ownership interests, and centralized management by its officers and directors.

Limited liability means that shareholders are not typically liable for the obligations of the corporation. Instead, their liability is limited to the amount of their investment in the stock of the corporation. Shareholders may be liable for corporate obligations if corporate formalities are not followed and a creditor can convince a court that it was appropriate to “pierce the corporate veil” to reach the shareholder’s personal assets. A shareholder may also be responsible for corporate obligations arising out of the shareholder’s own bad acts, such as breaching a legal duty to other shareholders or the corporation. Finally, a shareholder may voluntarily waive some of the limited liability protection offered by a corporation by personally guaranteeing certain obligations of the corporation like a line of credit or lease.

A corporation is governed by its articles and its bylaws. Like articles of incorporation, bylaws may include various permissive and discretionary provisions which may be very important to the governance of the business and limiting risk. A corporation must also follow “corporate formalities” such as keep minutes of annual and special meetings of its shareholders and directors to avoid having its corporate veil pierced. The shareholders may also desire to have certain management and shareholder agreements like a buy-sell agreement which restricts the shareholders’ ability to sell his or her ownership. Buy-sell agreements determine how business owners may later part ways and can prevent the remaining owners from having to be in business with someone not of their choosing.

Management of the corporation as governed by its bylaws unless no bylaws are prepared, in which case it is governed by state statute. Management of a corporation is entrusted to its directors who are elected by its shareholders. Directors may delegate certain duties of management to officers. In new, small, and closely-held corporations, the shareholders often appoint themselves as directors and officers. In that case, the shareholders should avail themselves of many of the permissive and discretionary provisions which may be included in the corporation’s articles and bylaws. Some of the optional provisions include providing for the indemnification and elimination of liability of directors in certain circumstances.

A common type of corporation is the C-corporation which is a for-profit, state-incorporated business. C-corporations can take advantage of corporate benefit plans, health plans, and retirement plans that are not available to some non-corporate businesses. Also, the C-corporation is easiest entity for raising capital. The primary disadvantage of a C-corporation is that it is subject to double taxation. That is, the corporation’s income is taxed at the corporate level and then, when its shareholders receive dividends or other distributions, taxed again on the shareholders’ personal tax returns.

Under the Internal Revenue Code, Subchapter S, certain corporations may elect “S-corporation” treatment. An S-corporation is a corporation that elects not to have its income taxed at the corporate level. Rather, it is a “pass-through” entity which means its shareholders are allocated a pro rata share of the corporation’s net income that they then must report on their individual tax returns. To qualify for S-corporation treatment, the corporation must have a limited number of shareholders who generally must be U.S. citizens or resident aliens, must have no more than one class of stock, and generally may not have any entities as shareholders. Further, all of the corporation’s shareholders must approve the election to be taxed as an S-corporation and file the appropriate IRS forms within seventy-five days after incorporation. The S-corporation offers the same limited liability protection for its shareholders, perpetual existence independent from its shareholders, and centralized management. However, given the Internal Revenue Service regulation, transferability of ownership interests is not as easy as that of a C-corporation.

Limited Liability Companies

Limited liability companies (LLCs) provide limited liability to its owners, usually referred to as “members.” An LLC is formed when it files articles of organization with the secretary of state in the state of organization and pays the appropriate filing fee. Like partnerships, most limited liability companies are pass-through entities for federal income tax purposes. However, its members may elect corporate tax treatment. If an LLC has only one member, the member can elect to have the entity disregarded for federal tax purposes. The LLC will enjoy state provided limited liability, but sole proprietorship tax treatment.

An LLC may be managed by its members or managers chosen by its members. Depending on the owner’s desires, the election of how the LLC is managed from the beginning can be very important. The governing document for an LLC is its operating agreement – the rough equivalent of corporate bylaws. An operating agreement need not be in writing, but most state statutes offer the LLC and its members additional limited liability and other permissive provisions that must be specifically included in the operating agreement for the LLC to avail itself of the maximum possible protection. Operating agreements may also include a buy-sell agreement and a management agreement within the document.

- Employee stock ownership plans
- Whether the company is required to register to do business in foreign jurisdictions
- Employee and independent contractor issues, agreements, handbooks, and policies
- Intellectual property protection for copyrights, trademarks, patents, and trade secrets
- Employee benefits (including owner-employees) such as ERISA benefit plans, health insurance plans, vacation and leave policies
- Various business insurance

Most lawyers tend to have two types of clients: the first type of client is the client who is willing to seek and pay for preventative legal measures to limit future risks and taxes; the second type of client is the one who is unwilling to seek advice and plan in advance.

Depending on the level of planning up front, which in some instances may be perceived as expensive, the first type of client almost always pays a small fraction in legal fees than the second type of client. This is true because it often is the second type of client who later finds himself or herself in expensive, unpredictable, and largely uncontrollable litigation possibly resulting in a judgment against the business and, in some instances, the owners themselves.

Good planning with competent legal counsel from the beginning can help you protect your business, your personal assets, and (like preventative medicine or car maintenance) can save you significant money later.

LLC versus a Corporation: What are the Principal Non-Tax Differences?

All corporations formed under the CBCA have certain common structural characteristics, and any deviations can be found in the corporation’s articles of incorporation. On the other hand, LLCs formed under the Colorado LLC Act are primarily contractual creatures that can be designed to fulfill the organizers’ intentions. The following table sets some of this information forth:

	Corporation	LLC
Formation	Filing articles of incorporation with the Secretary of State (“SOS”) §7-102-102	Filing articles of organization with the SOS §7-80-204
Transparency	Material provisions regarding capitalization, board of directors, limitation of liability, and other provisions included in articles or statutory default	No material provisions included in articles. Statutory default is likely unacceptable
Bylaws/Operating Agreement	Bylaws may contain some material provisions (such as nominating procedure for directors), but generally not material to governance §7-102-107	Operating agreement is the contract between the members. May be oral, but statute of frauds issue.
Unauthorized assumption of powers	§7-102-104	§7-80-105
Capital Structure	Set forth in articles, but generally common stock and perhaps preferred stock	“Membership interest” defined by reference to the investment, unless otherwise set forth in the operating agreement
Capitalization	Defined capital structure in articles (authorized shares by number and class) §7-106-101, -102	Usually unlimited capital structure, but subject to definitions in operating agreement
Issuance of Equity	Defined requirements §7-106-202	Established in operating agreement
Profit motive	Corporation must have a profit motive.	LLC need not

	Corporation	LLC
Purposes	Can be narrow or broad; more often purposes should be broadly written	Can be narrow or broad; more often purposes should be narrowly written
Limitations of Liability of Equity Owners	Statutory §7-106-203, “unless otherwise provided in articles”, and §7-108-402 (exoneration)	§7-80-705 (applies to members and managers)
Exceptions	Persons own acts or conduct	Same
	Unpaid portion of subscription §§ 7-106-201, 203	§7-80-502
	Wrongful distributions § 7-106-401, §7-108-403	§7-80-606
Standards of conduct	§7-108-401 (generally the duty of care) and §7-108-501 (duty of loyalty)	§7-80-108, 404. All duties can be waived or modified except the contractual obligation of good faith and fair dealing
Piercing the veil to impose liability on owner	Common law	Statutory (§7-80-107 applies corporate common law)
	No preemptive rights unless granted in articles §7-106-301	No preemptive rights unless set forth in operating agreement
Owner action	Generally a majority of shares voting; occasionally a majority of the outstanding §7-107-206	Generally unanimous unless agreed otherwise; exception is for removal of manager which requires a majority of members (not membership interest §7-80-402)
		See §7-80-401 requiring vote of a majority of the members or managers, as applicable
	Generally vote by number of voting shares §7-107-202	Generally <i>per capita</i> vote unless otherwise agreed §7-80-401

	Corporation	LLC
	All holders of a class of stock entitled to vote are entitled to vote	Must be a member to exercise the rights to vote. Assignees who have not been admitted do not have right to vote
Collective action	Board acts collectively §7-108-101; officers within the scope of their authority §7-108-301	Managers (or members of member-managed) are agents for the purpose of the business of the LLC §7-80-405
Rights of creditor against owner	Foreclosure resulting in rights of a shareholder	Charging order or foreclosure of membership interest (resulting in rights of assignee) § 7-80-703
Security interest	Pledge of certificated interests under article 8 of the UCC	Must elect article 8 treatment, and then still must perfect under article 9 (a control agreement, generally required)
Derivative proceedings	§7-107-401 <i>et seq.</i>	§7-80-713 <i>et seq.</i>
Voluntary dissolution	§7-114-101 <i>et seq.</i>	§7-80-801 <i>et seq.</i>
Judicial dissolution	§7-114-301 <i>et seq.</i>	§7-80-810 <i>et seq.</i>
Administrative dissolution	None; delinquency in §7-90-901 <i>et seq.</i>	Same
Annual meetings	Required §7-107-101	Only if required by agreement

Statutory law bears an important role in the choice of form and structure decision. The statutes of a jurisdiction in which an organization is formed (the “organic statutes”) are increasingly important in the choice of form and structure of business organizations. The organic statutes in Colorado for the purposes of this paper are the Colorado LLC Act and the CBCA. They attempt to codify, or in some cases change, the common law. The Colorado LLC Act and the CBCA also contemplate an agreement among owners and managers that may modify the rules otherwise applicable under the Colorado LLC Act and the CBCA and the common law.

There are other laws that are potentially applicable to entities formed under the CBCA, the Colorado LLC Act, and the other Colorado organic statutes. These include

statutes that describe the application of other laws to the entity, such as tax statutes, bankruptcy law, securities regulation, and laws regulating specific activities or businesses.

The existence and operation of any business organization is governed by a combination of organic statutes, these other laws and regulations, agreements of the owners and managers, and common law. In most cases, the organic statutes provide the legal basis for the existence of the organization as a legal entity and provide rules which govern the relationship of the owners and managers *inter se* and the manner in which the organization acts with respect to third parties, *i.e.*, the agency and decision-making authority of the constituents of the entity. The organic statutes include rules that can be modified by the agreement of the owners and managers (“default rules”) and rules that may not be varied by agreement (“mandatory rules”).

Mandatory rules set forth in organic statutes such as the CBCA and the Colorado LLC Act generally prevail over any contrary agreements among parties and have the effect of overruling contrary common law. Similarly, organic statutes may allow the owners of an organization to take action even if such action would have been proscribed under common law in effect before the adoption of the organic statute. Thus, for example, the organic statutes may modify the duties owed by owners or managers to each other under common law in effect before the adoption of the organic statute. Some more recent organic statutes, such as the Colorado LLC Act, transform some existing common law into default rules that may be modified by the owners and managers by their agreement.

Organic statutes generally set forth rules regulating more mundane aspects of the entity sometimes referred to as “plumbing.”⁶ These plumbing issues include such matters as the contents of filed documents, annual reporting, and permissible names for the entity. Among other functions, plumbing rules generally constitute a statutory rubric under which business entities may be found and kept track of by the state filing officer and provide a framework under which certain types of transactions may be accomplished. As noted above, many states are combining many “plumbing” issues into multi-form statutes that provide common statutory provisions to different forms of entity. In Colorado, these are found in the Colorado Corporations and Associations Act.⁷

Perhaps the most significant aspect of the organic statutes is the degree to which they consist of default rules that can be modified by agreement or mandatory rules that are non-waivable. The Colorado LLC Act provides the ability to waive a number of duties that might be referred to as fiduciary,⁸ while the CBCA does not provide for such waivers.

⁶ See, Keatinge, *Plumbing And Other Transitional Issues*, 58 Bus. Law. (ABA) 1051 (May 2003).

⁷ Colo. Rev. Stat. § 7-90-101, *et seq.*

⁸ Colo. Rev. Stat. § 7-80-108.

In a purely contractual arrangement such as is contemplated for an LLC, the ability to modify the relationship by agreement is limited only by considerations such as fraud or public policy, illegality or other contractual policing techniques that would make a contract otherwise unenforceable.⁹ Ordinarily a purely contractual agreement does not entail fiduciary duties. If, however, one party agrees to act as an agent for another, or one party resides trust and confidence in another, such agreement may create the fiduciary duties that ordinarily accompany an agency or common law fiduciary relationship.

In an LLC, members may draft relationships among themselves in an operating agreement. Notwithstanding the legislative desire to give maximum effect to the principle of freedom of contract,¹⁰ the Colorado LLC Act does contain some restrictions on the ability of the operating agreement to reflect the member's agreement.¹¹ An operating agreement may not:

- Unreasonably restrict the rights of members and managers for access to books and records of the LLC under C.R.S. § 7-80-408.
- Eliminate the “contractual obligation of good faith and fair dealing” under C.R.S. § 7-80-404(3).
- Restrict rights of, or impose duties on, persons other than the members, their assignees and transferees, and the limited liability company without the consent of such persons.

Furthermore, no operating agreement may vary any requirement under the Colorado LLC Act that a particular action or provision be reflected in writing unless the variance is approved as the written operating agreement requires.¹²

Unlike the current versions of the uniform unincorporated acts such as the Colorado LLC Act, the Delaware Limited Liability Company Act (the “DLLCA”):

- permits a limitation or complete elimination of fiduciary duties,¹³

⁹ See Restatement (Second) of Contracts § 179 (1981).

¹⁰ C.R.S. § 7-80-108(4).

¹¹ C.R.S. § 7-80-108(2).

¹² C.R.S. § 7-80-108(3)(d).

¹³ 6 Del. Code § 18-1101(d) (a member's or manager's duties may be "expanded or restricted or eliminated" provided that the agreement may not "eliminate the implied contractual covenant of good faith and fair dealing."

- protect partners, members, and managers relying in good faith on the agreement,¹⁴ and
- allow the members to provide contractual limitation of liability for good faith breach of the agreements.¹⁵

While many of the governing provisions of corporate law may be modified by agreement in the articles of incorporation, bylaws, or a shareholder's agreement, the overarching managerial structure and fiduciary duties of corporate management are less flexible than the infrastructure of an LLC. Thus typically in corporate law:

- shareholders have one vote per share;
- the board of directors has primary authority to manage the business and affairs of the corporation until the next annual election; and
- the officers serve as agents of the corporate enterprise at the behest of the board.

In a corporation, there are two principal types of vicarious liability with which owners and managers must be concerned:

- * personal liability of an owner or manager to the organization's creditors for obligations of the organization whether by reason of the person's status as an owner or manager or by reason of some action of the owner or manager, and
- * liability of owners to contribute to the organization or to restore wrongful distributions (i.e., a "clawback" obligation).

Members and managers in an LLC are not liable for any debt, obligation, or liability of the LLC except to the extent a member (or in some judicial decisions a manager) can be held liable under the theory of piercing the veil or for wrongful distributions.¹⁶

¹⁴ 6 Del. Code § 18-1101(e) (a member or manager shall not be liable to a LLC or to another member or other person bound by the agreement for acts taken in good faith reliance on the provisions of the agreement).

¹⁵ 6 Del. Code § 18-1101(f) (a member's or manager's liabilities for breach of contract and breach of duties (including fiduciary duties) to a LLC or to another person that is a party to or is otherwise bound by a limited liability [operating] company agreement may be limited or eliminated, that the agreement "may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing").

¹⁶ See, generally, Lidstone, "Piercing the Veil of an LLC or a Corporation," 39 *The Colorado Lawyer*, no 8 at 71 (August 2010); Chapter 32, "Piercing the Corporate Veil," Rozansky and Reichert, *The Practitioner's Guide to Colorado Business Organizations* (CLE in Colorado, 2008).

The shareholders, directors, and officers are not, as such, liable for the obligations of the corporation. Directors, however, are personally liable to shareholders, to the corporate enterprise for waste and breach of fiduciary duties, and possibly creditors if the corporation is insolvent.¹⁷

The organic statutes providing the default rules for financial relationships differ considerably among the forms of entity. As a general matter, unincorporated organizations such as LLCs base their economic relationship on the capital account system whereby each owner has an account that is increased by the contributions made by the owner as well as the owner's share of profit and is decreased by distributions to the owner and the owner's share of losses. These "sharing ratios" can be changed by agreement.

Corporations, on the other hand, declare "dividends," which are distributed *pro rata* based on the number of shares of stock owned unless there are special classes of stock.

Both the Colorado LLC Act and the CBCA limit distributions when the organization is, or as a result of the distribution will become, insolvent.

The Colorado LLC Act and the CBCA provide a variety of rules governing decision-making. Absent a contrary provision in the operating agreement the Colorado LLC Act provides for consent by a majority of the members on a *per capita* basis.¹⁸ The default rules under the Colorado LLC Act require unanimous consent for certain extraordinary transactions.¹⁹ The LLC Act specifies certain provisions that directly or indirectly address when LLC members and managers are entitled (or required) to vote:

- § 7-80-401(1) states the general rule that, unless an agreement provides otherwise and unless the LLC is manager-managed, "decisions with respect to a limited liability company shall be made by a majority of the members."²⁰
- § 7-80-706 sets forth the general provision establishing the right to vote to members as may be set forth in the operating agreement, "subject to the provisions of this article that require majority or unanimous consent."

¹⁷ *Alexander v. Anstine*, 152 P.3d 497 (Colo. 2007), footnote 9.

¹⁸ C.R.S. § 7-80-

¹⁹ *See e.g.*, C.R.S. § 7-80-801(1)(a) (dissolution).

²⁰ C.R.S. § 7-80-102(9) defines the term "member" as a person; § 7-80-102(10) defines the term "membership interest." The statutory voting provisions use the term "member," not "membership interest." This may lead to an unusual result that two 1% owners could outvote a 98% owner absent an agreement to the contrary.

- § 7-80-101(11) provides that the operating agreement is the agreement of **all** members – requiring unanimity.
- The statute provides that a unanimous vote of the members is required to take the following actions, unless the operating agreement provides otherwise:
 - § 7-80-209(1.5) – To amend articles of organization
 - § 7-80-401(2) – To amend articles or operating agreement, or take any action that is not in ordinary course
 - § 7-80-502 – To compromise obligation of member to make contribution
 - § 7-80-701 – To admit new members to the LLC
 - § 7-80-801 – To approve the dissolution of the LLC
- § 7-80-402 provides that (unless otherwise provided in the operating agreement) a majority of members (not “membership interest”) to designate or remove managers.

The operating agreement can generally change any of the foregoing voting requirements, including adding circumstances where manager vote is also required and changing the *per capita* voting to a membership interest voting provision. The statute does not specifically require any manager approval.

Under the Colorado LLC Act, the managers of a manager-managed LLC and the members of a member-managed LLC each has the power to bind the entity when apparently carrying on the business of the organization in the usual way.²¹ On the other hand, the DLLCA permits both members and managers to retain agency power notwithstanding the internal organization of the LLC.²² Like most corporate acts, the CBCA provides that the board of directors will act as a group and no director has the power to act individually unless authorized to do so by the Board of Directors. Officers of a corporation generally have apparent authority to act on behalf of the corporation, but their actual authority can be limited or expanded by resolution of the Board.

The agency issues deserve greater treatment. *Water, Waste & Land, Inc. d/b/a Westec v. Lanham*²³ is a case from the Colorado Supreme Court that arose shortly after LLCs became a frequently-used business entity. Lanham and Clark were members and managers of Preferred Income Investors, LLC (“Preferred”). Clark contacted and contracted with Westec for engineering services. Clark’s business card included his name, address, and the initials “PII”, but not the name of the LLC or his title. On Clark’s instructions, Westec sent a written proposal to Lanham, but commenced work on Clark’s oral authorization. Westec never received the signed contract and, when the work was done, never received

²¹ C.R.S § 7-80-405.

²² 6 Del. Code § 18-402 (“Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company.”).

payment. Westec sued both Clark and Lanham as well as Preferred. Preferred admitted liability while Clark and Lanham defended based on the shield provided by Preferred. In reaching its decision in this case, the Supreme Court said that agency law applies in the LLC context, “notwithstanding the LLC’s statutory notice rules,” continuing:

Under the common law of agency, an agent is liable on a contract entered on behalf of a principal if the principal is not fully disclosed. . . . If both the existence and identity of the agent’s principal are fully disclosed to the other party, the agent does not become a party to any contract which he negotiates. . . . But where the principal is partially disclosed (i.e., the existence of a principal is known but his identity is not), it is usually inferred that the agent is party to the contract.²⁴

The Court went on to say, “The duty of disclosure clearly lies with the agent alone; the third party with whom the agent deals has no duty to discover the existence of an agency or . . . the identity of the principal.” As a result, the Court reversed the judgment of the District Court and reinstated the judgment of the County Court which had held Lanham and Clark personally liable as agents for (at best) a partially disclosed principal.

C.R.S. § 7-80-405(1)(a) provides that a member “has no authority to bind the [LLC] solely by virtue of being a member” of an LLC where the articles of organization provide that the LLC is to be managed by managers. C.R.S. § 7-80-405(1)(b) goes on to state that any manager of a manager-managed LLC does have the right to bind the LLC. Thus, each and every manager of an LLC is an agent for the LLC and can bind the LLC, with two exceptions:

- First, the act taken by the manager must be “for apparently carrying on in the ordinary course of business of the [LLC].”²⁵
- Second, if the articles of organization or the operating agreement limit any manager’s ability to act for the LLC and the third party had notice of the limitation, the manager’s act would be invalid.²⁶

The first limitation can be defined by the LLC’s course of business over a period of time. Where a manager of an LLC conducting business as a hardware store decides to sell the property underlying the store, such an action can reasonably be seen as not for the purpose of “carrying on in the ordinary course.” There may be many other actions that are a

²³ 955 P.2d 997 (Colo. 1998).

²⁴ 955 P.2d at 1001.

²⁵ C.R.S. § 7-80-405(1)(b).

²⁶ C.R.S. § 7-80-405(1)(b).

much closer call, such as a bulk sale of inventory. C.R.S. § 7-80-405(1)(b) appears to place the risk of determining whether the manager's action is "in the ordinary course" on the third party, however.

The second limitation is problematic. Many LLCs want to restrict their managers as a board of directors – not giving any manager the ability to act on behalf of the LLC individually, but only collectively. Limitations such as this can be written in the articles of organization or in the operating agreement – but no such limitation has any effect unless the other party to the contract has actual notice of the limitation. Neither the articles of organization (which are filed with the Secretary of State) nor the operating agreement (which is not) provide constructive notice.

C.R.S. § 7-80-405(2) describes the relationship of members in an LLC managed by members similarly.

- The act of any member "for apparently carrying on in the ordinary course of business of the [LLC]" binds the LLC.
- "unless the member had no authority to act for the [LLC] in the particular matter and the person with whom the member was dealing had notice that the member lacked authority."

Notably, in an LLC managed by the members, even non-voting members would have the ability to bind the LLC if the actions are "apparently" for the purpose of carrying on the LLC's business.

The most important limitation on the ability of managers and members to act for an LLC with the authority given by C.R.S. § 7-80-405 is found in C.R.S. §7-80-404(3) and discussed above – the requirement that members and managers each discharge his or her "duties to the [LLC] and exercise any rights consistently with the contractual obligation of good faith and fair dealing." This is, of course, subject to the member's rights to "determine the standards by which the performance of the obligation is to be measured, if such standards are not unreasonable."²⁷ The comparable rules applicable to corporations under the CBCA are the director's duties of care and loyalty which are higher standards and which cannot be modified by contract.

The contractual obligation of good faith and fair dealing applies to each member (whether in a member-managed or manager-managed LLC) and to each manager. This obligation is a basic tenet of contract law in Colorado.²⁸ Colorado law provides that every

²⁷ C.R.S. § 7-80-108(2)(d).

²⁸ C.R.S. § 7-80-108(2)(d). *See, e.g., Cary v. United of Omaha Life Insurance Company*, 68 P.3d 462, 466 (Colo. 2003); *Mahan v. Capitol Hill Internal Medicine, P.C.*, 151 P.3d 685, 690 (Colo. App. 2006)

contract, including an operating agreement, contains an implied duty of good faith and fair dealing in each party's performance and enforcement.²⁹ The doctrine exists under Colorado law to effectuate the parties' intentions and honor their reasonable expectations, and violating the duty of good faith and fair dealing may give rise to a claim for breach of contract.³⁰ Of course, determining whether a violation occurred because one of the parties breached its obligations of good faith and fair dealing is a factual question.³¹ Delaware law provides similarly; in *Kelly v. Blum*,³² the covenant of good faith and fair dealing was held to require parties to refrain from arbitrary or unreasonable conduct that prevents the other party from receiving the fruits of the contract.

“In the narrow context governed by principles of good faith and fair dealing, [the Delaware Supreme] Court has recognized the occasional necessity of implying such terms in an agreement so as to honor the parties' reasonable expectations. [Citation omitted] But those cases should be rare and fact-intensive, turning on issues of compelling fairness” and should be “a cautious enterprise.”³³ While the cases the Delaware Court relied on were employment cases, the Court went on to say: “This Court should be no less cautious or exacting when asked to imply contractual obligations from the written text of a limited partnership agreement.”³⁴ There the Court found that the unambiguous terms of the limited partnership agreement defeated the plaintiff's case and, therefore, there was no need to address the plaintiff's claim further.

In Colorado, the Court of Appeals noted that the “duty of good faith and fair dealing may be relied upon ‘when the manner of performance under a specific contract term allows for discretion on the part of either party.’”³⁵ “Discretion in performance occurs ‘when the

²⁹ *Cary v. United of Omaha Life Insurance Company*, 68 P.3d 462, 466 (Colo. 2003); *Amoco Oil Co. v. Erwin*, 908 P.2d 493, 498 (Colo. 1995); *Mahan v. Capitol Hill Internal Medicine, P.C.*, 151 P.3d 685, 690 (Colo. App. 2006); *Wells Fargo Realty Funding Advisors, Inc. v. Uioli, Inc.*, 872 P.2d 1359, 1362 (Colo. App. 1994).

³⁰ *City of Golden v. Parker*, 138 P.3d 285, 292 (Colo. 2006); *Bloom v. Nat'l Collegiate Athletic Assn*, 93 P.3d 621, 624 (Colo. App. 2004). *Bloom* cited various authorities for the proposition that the duty of good faith and fair dealing requires that a party vested with contractual discretion exercise that discretion reasonably, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.

³¹ *Platt v. Aspenwood Condominium Assn*, 214 P.3d 1060, 1066 (Colo. App. 2009).

³² 2010 WL 629850 (Del. Ch. Feb. 24, 2010) at n. 95 [citing *Kuroda v. SPJS Hldgs., L.L.C.*, 971 A.2d 872, 887 (Del.Ch.2009) (citing *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005)].

³³ *Cincinnati SMSA Ltd. P'Ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998).

³⁴ *Cincinnati SMSA Ltd. P'Ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998).

³⁵ *New Design Construction Company, Inc. v. Hamon Contractors, Inc.*, 215 P3d 1172 (Colo. App. 2008). There the Court of Appeals stated that “Hamon's interpretation of the contract documents-that it had the power to dictate how, when, and where NDCC performed its work-without incorporating the implied covenant of good faith and fair dealing could lead to an absurd result. . . . As NDCC pointed out, if the implied

parties, at formation, defer a decision regarding performance terms of the contract' leaving one party with the power to set or control the terms of performance after formation."³⁶ The Court of Appeals has found that a breach of the contractual covenant may occur "[w]hen one party uses discretion conferred by the contract to act dishonestly or to act outside of accepted commercial practices to deprive the other party of the benefit of the contract."³⁷

The covenant of good faith and fair dealing in the LLC Act and the implied covenant in contracts truly comes into play when a contract is ambiguous or when the mechanism or timing for the exercise of discretion is not well defined. Whether a contract is ambiguous is a question of law.³⁸ Courts have held that a contract is ambiguous when it is reasonably susceptible of more than one meaning.³⁹ "The mere fact that the parties differ on their interpretations of an instrument does not of itself create an ambiguity."⁴⁰ The law implies the covenant to prevent one party from unfairly taking advantage of the other party. Therefore, by definition the covenant does not apply to modify or to enforce violations of express provisions of the operating agreement. The duty of good faith and fair dealing does require that a party vested with contractual discretion exercise that discretion reasonably, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.⁴¹ In *Hamon*, the Court of Appeals accepted evidence as to the custom in the industry for defining performance obligations.⁴²

Where, as in the LLC Act, there is great flexibility given to the contract, "implying obligations based on the covenant of good faith and fair dealing is a cautious enterprise," and the implied covenant is not a safety net for less-than-prescient drafting.⁴³ Courts have

covenant of good faith and fair dealing were not incorporated into the contract documents, *Hamon* could have required it 'to perform its paving work at midnight using teaspoons.'" *Citing City of Golden v. Parker*, 138 P.3d 285, 292 (Colo. 2006) (quoting *Amoco Oil Co. v. Ervin*, 908 P.2d 493, 498 (Colo.1995)).

³⁶ *Id.* (quoting *Amoco Oil Co.*, 908 P.2d at 498). *Cf. Tricon Kent Co. v. Lafarge North America, Inc.*, 186 P.3d 155, 158 (Colo. App. 2008).

³⁷ *Wells Fargo Realty Funding Advisors, Inc. v. Uioli, Inc.*, 872 P.2d 1359, 1363 (Colo. App. 1994), *citing* Restatement (Second) of Contracts, § 205 cmt. A (1981).

³⁸ *Pub. Serv. Co. v. Meadow Island Ditch Co. No. 2*, 132 P.3d 333, 339 (Colo. 2006).

³⁹ *Ad Two, Inc. v. City & County of Denver*, 9 P.3d 373, 376 (Colo. 2000).

⁴⁰ *Fibreglas Fabricators, Inc. v. Kylberg*, 799 P.2d 371, 374 (Colo. 1990).

⁴¹ *Bloom v. Nat'l Collegiate Athletic Assn*, 93 P.3d 621, 624 (Colo. App. 2004).

⁴² *New Design Construction Company, Inc. v. Hamon Contractors, Inc.*, 215 P.3d 1172, 1182 (Colo. App. 2008).

⁴³ *Cincinnati SMSA Ltd. P'Ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998).

described the implied covenant of good faith and fair dealing as “a judicial convention designed to protect the spirit of the agreement when, without violating an express term of the agreement, one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties’ bargain.”⁴⁴ In another case, the court said, “The implied covenant of good faith and fair dealing requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain.”⁴⁵

The Colorado LLC Act does permit the parties to use the operating agreement to “prescribe standards by which the performance of the obligation [of good faith and fair dealing] is to be measured, if such standards are not unreasonable.”⁴⁶ As noted, this duty applies whether the LLC is member-managed or manager-managed, and applies both to members and managers. As an example of the parties eliminating a reasonableness requirement in an operating agreement, see *Related Westpac LLC v. JER Snowmass LLC*. There, the Delaware Court of Chancery ruled that LLC members had the freedom to contract away an obligation by the members to act “reasonably” and, as a result, the failure by one party to act reasonably did not violate the contractual obligation of good faith and fair dealing.⁴⁷

There is a significant difference between the default rules with respect to transferability of interests in an LLC under the Colorado LLC Act and those applicable to corporations under the CBCA. Under the default rules under the Colorado LLC Act, the transfer of an “interest” in the entity does not vest the transferee with any right other than economic right—no management right, no right to inspect books and records, and no right to interfere in management.⁴⁸

⁴⁴ In *Bakerman v. Grey Goose*, 2006 WL 2987020 (Del.Ch. Oct. 10, 2006), quoting from *Chamison v. Healthtrust*.

⁴⁵ *Chrin v. Ibrix Inc.*, Civ. A20587, 2005 WL 2810599 at *7 (Del. Ch. Oct. 19, 2005), citing *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005).

⁴⁶ C.R.S. § 7-80-108(2)(d).

⁴⁷ C.A. No. 5001-VCS, 2010 WL 2929708, (Del. Ch., Jul. 23, 2010). In *Related Westpac*, Related, JER, and a third (passive) investor formed two LLCs for a redevelopment project in Snowmass, Colorado. Under the operating agreements, Related was to act as manager and JER was to provide funding. The operating agreement required the manager to obtain JER’s consent for 23 different category of “Major Decisions” and JER’s ability to withhold its consent in most of those cases was subject to a reasonableness standard. “Major Decisions” that constituted a “Material Action” were expressly not subject to a reasonableness standard, and JER could withhold its approval in its sole discretion. When JER did so, Related brought suit for damages. The Chancery Court reviewed the operating agreement and refused to “imply a reasonableness condition as part of the Operating Agreements’ implied covenant of good faith and fair dealing” since the Operating Agreement expressed the agreement of the parties over the subject matter of the action and the Court “cannot imply an obligation inconsistent with the parties’ express agreement.”

⁴⁸ C.R.S. § 7-80-407.

A membership interest in an LLC is personal property,⁴⁹ and therefore should be treated as personal property under the Uniform Commercial Code, and may be assigned.⁵⁰ Unless otherwise stated in the operating agreement, however, the LLC has no obligation to admit the assignee as a member, and unless admitted as a member, the assignee only has the economic rights attributable to the membership interest assigned – the assignee does not have voting or other rights that a member may have. The admission of the assignee as a member “terminates the assignor’s . . . rights and powers as a member with respect to the portion of the membership interest assigned . . . and releases the assignor . . . from liability to the [LLC] other than for liabilities under § 7-80-502 [liability for contributions] or 7-80-606 [liability for distributions].”⁵¹ Section 7-80-701 requires a unanimous vote of the other members for the admission of new members, but this can be reduced in the operating agreement.⁵²

In contrast, the transfer of stock in a corporation transfers economic rights as well as the voting rights of the shares—generally one vote per share. This critical distinction between an "interest" in an unincorporated entity and "stock" in a corporation is one often overlooked and greatly misunderstood.

Corporate law has long permitted creditors to disregard the liability protection of a corporation or other limited liability entity where evidences of fraud or equity render it appropriate to disregard the organizational veil and hold the owners personally liable for the obligations of the organization. Generally, when organizational formalities are observed, financing is adequate, and the organization is not formed or used to defraud creditors or other third parties, the liability protection of the organizational form is respected and owners are be liable for the organization's debts and liabilities.

On the other hand, the organization may be disregarded and owners may be held personally liable for some or all of the obligations of the organization if the owner disregards the separateness of the organization, commingles assets, undercapitalizes the organization, forms or uses the organization for personal use or to perpetrate a fraud on

⁴⁹ C.R.S. §7-80-702(1).

⁵⁰ Taking an LLC interest as collateral for repayment of a debt is complicated and is discussed in more detail below in Lidstone, *Limited Liability Companies in Colorado*, § 5.4.1, “Taking Interests in LLPs and LLCs as Security for Debt Repayment.”

⁵¹ C.R.S. §7-80-702(2).

⁵² As discussed, the operating agreement can provide for admission of new members by less than a unanimous vote of the members, or even by the managers. See Section 11.5 of Exhibit 1. This offers two possibilities – either admission by Three-Quarters Vote of the Members, or by the Managers. Care should be taken in determining whether the persons organizing the business want to make it more or less difficult to add new Members.

creditors, or fails to observe the organizational formalities associated with the organization. Statistics indicate that veil piercing is most likely to occur in the case of organizations with fewer than 10 owners and by creditors with contractual claims. As the ownership of the entity decreases, the likelihood of veil piercing increases.

Because veil piercing is a common law doctrine, the circumstances under which “piercing” will occur is fact specific and determined on an *ad hoc* basis.⁵³ As a common law theory applicable to corporations, whether piercing should ever apply to unincorporated organizations is a source of great uncertainty. For example, two of the most common reasons for piercing the veil of a corporation are the failure to follow corporate formalities and undercapitalization of the enterprise. In unincorporated entities, formalities do not exist and the capitalization structure of a corporation is also nonexistent in unincorporated statutes. Nevertheless, the Colorado LLC Act specifically provides that the liability shield of an LLC can be pierced by applying the corporate case law, but that, for piercing purposes, failure to observe formalities will not be considered a negative piercing concept.⁵⁴ The DLLCA does not expressly address the question of piercing.

“Reverse piercing” is a common law doctrine pursuant to which a court may disregard the separate existence of an organization or otherwise make the assets of the organization available to satisfy the obligations of an owner. Reverse piercing also occurs where owners of a corporation seek to disregard the corporation's existence in order to take advantage of other law, *e.g.*, homestead exemptions or state unemployment benefits where stockholders take turns laying each other off during down times of the corporation. While “reverse piercing” often relies on the same disregard of organizational existence as piercing, it is a fact intensive test that often trades in equity in order to allow either creditors or

⁵³ See, Robert B. Thompson, *Piercing The Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036 Cornell Law Review (July, 1991) (analyzing the characterization of the grounds on which piercing was sought into the following characteristics: Instrumentality (pierced successfully in 97.33% of the cases), Alter Ego (95.58%), Misrepresentation (94.08%), Agency (92.31), Dummy (89.74%), Lack of Substantive Separation (85.11%), Intertwining (85.71%), Undercapitalization (73.33%), Informalities (66.89%), Domination & Control (56.99%), Overlap in officers (50.00%), Overlap in directors (43.42%), Overlap in owners (48.51%); Overlap in office (58.82%), Overlap in business activity (81.40%), Overlap in employees (69.23%), Overlap in management (65.12%, Other overlap (69.82%), Total overlap (56.53%)), and Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 Wake Forest L. Rev. 1, 7 (1997) (noting that while piercing may be supported for a variety of reasons, it is always applied in the context of closely held corporations).

⁵⁴ C.R.S. § 7-80-107(1) which provides: “In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law. (2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company.”

owners to succeed to and enforce the rights of owners or owners to equitably enjoy rights under other law.

The Process of Incorporation Versus LLC Formation

Another significant point that must be considered is selecting the state in which to form your entity. For a Colorado business planning to do business in Colorado, the choices are two: Colorado or Delaware. Ultimately the correct answer to that question will likely be Colorado. Most lawyers do not know Delaware corporate or limited liability company law; to incorporate in Delaware you will need a professional service company to make the filings for you and to serve as registered agent in a state in which you are not otherwise doing business, and the franchise fee for Delaware corporations is many times the cost in Colorado. Even the annual cost to maintain an LLC in Delaware (\$50 plus service company fees) is greater than Colorado (\$10).

There is little lost by organizing your new business in Colorado. The Colorado statutes are flexible and up to date. The filing costs are nominal, and the cost of the annual reports are small (\$10.00). To the extent there is a downside to incorporating a corporation or organizing an LLC in Colorado, it has to do with dispute resolution. Delaware Chancery Courts are experienced in business litigation and issue consistent decisions. Colorado does not have a business court, and the courts have issued inconsistent decisions, some of which are demonstrably wrong. Where venture capitalists are expected to be involved in financing the entity, or where financing may be expected from countries outside the United States, the financing parties may insist on Delaware law since they may be more familiar with the requirements and benefits of Delaware law.

Under Colorado law, the process of forming an LLC or incorporating a corporation is not difficult, although both have the potential for bad decisions and error.

An LLC is formed by filing the articles of organization with the Colorado Secretary of State in a form provided by the Colorado Secretary of State. There is little room for error except in determining whether to form a manager-managed LLC or a member-managed LLC. The correct answer to that is a manager-managed LLC, with a member-managed LLC being the correct answer in very few cases. If the articles of organization are silent, the management will be vested in the members of the LLC.⁵⁵ Limitations on the authority of managers or members that are contained in the articles of organization are ineffective except against those with actual notice of the limitations.⁵⁶

Incorporation of a corporation under the CBCA is equally simple since the Secretary of State has provided an appropriate form, but merely completing the form is never a good

⁵⁵ C.R.S. § 7-80-204.

⁵⁶ C.R.S. § 7-80-208.

idea. The CBCA provides for a number of provisions that are effective only if set forth in the articles of incorporation. These can be set forth in an attachment to the articles of incorporation and, unlike the LLC, these additional provisions do constitute constructive notice.

Drafting an operating agreement for any limited liability company can be extremely intimidating. We have discussed the default provisions above, which are seldom acceptable to the parties should they take the time to think about it. It is important to note that the operating agreement has much more flexibility in its drafting than does any other entity agreement. The warning stated by Vice Chancellor Strine of the Delaware Court of Chancery has real meaning, however: “With the contractual freedom granted by the LLC Act comes the duty to “scriven with precision.”⁵⁷

There is less freedom of contract in the corporation’s bylaws, although once again there are choices that can be made.

The third part of the corporate scheme is generally the buy-sell agreement. The corporate buy-sell agreement is generally a separate agreement, not a part of either the articles of incorporation or the bylaws.⁵⁸ The buy-sell agreement for an LLC generally appears in an LLC operating agreement.

Walking the Ethical Line

In considering ethical issues, it is important to note Paragraph [20] of the scope of the Colorado Rules of Professional Conduct which states:

“Violation of a Rule should not give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached.”

⁵⁷ *Willie Gary LLC v. James & Jackson, LLC*, 2006 WL 75309, at *2 (Del.Ch.Ct. Jan. 10, 2006), affirmed *sub nom. James & Jackson, LLC v. Willie Gary LLC*, No. 59-2006 (Del. Sup. Ct. Mar. 21, 2006). There the issue was a dispute resolution clause which the court found was “unwieldy” but sufficiently clear to deny a motion to dismiss for arbitration of the claims. See, also, Kleinberger, “*Careful What You With For – Freedom of Contract and the Necessity of Careful Scrivening*” XXIV Pubogram 19 (October 2006), available at <http://ssrn.com/abstract=939009>.

⁵⁸ For a form of corporate buy-sell agreement, see Lidstone “*Form of Stock Redemption and Cross Purchase Agreement*” found in chapter 23 of Rozansky and Reichert, PRACTITIONER’S GUIDE TO COLORADO BUSINESS ORGANIZATIONS (Colorado Bar Assn. 2006-2010).

Rule 1.0(e) – Informed Consent

Many of the Rules of Professional Conduct require the client’s “informed consent” before the lawyer can take any action.⁵⁹ In some cases the rules require the client’s “informed consent confirmed in writing.” Rule 1.0(e) defines “informed consent” as follows:

“‘Informed consent’ denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.”

Comment [6] to Rule 1.0 explains “informed consent” further by saying: “[o]rdinarily, this will require communication that includes a disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client or other person of the material advantages and disadvantages of the proposed course of conduct and a discussion of the client’s or other person’s options and alternatives. In some circumstances it may be appropriate for a lawyer to advise a client or other person to seek the advice of other counsel.” Comment [7] goes on to say that a lawyer may not assume consent by the client’s silence: “[o]btaining informed consent will usually require an affirmative response by the client or other person.”

Where the informed consent must be “confirmed in writing,” Rule 1.0(b) provides that the writing may be signed by the client or may be a letter from the lawyer to the client confirming an oral informed consent given by the client. In some situations, the rules require the informed consent to be signed by the client, *e.g.* when engaging in a business transaction with a current client under Rule 1.8.

Rule 1.4 (Communication) requires that the lawyer, as a part of his or her duty to communicate with the client, fully inform the client about matters requiring the client’s “informed consent.” A failure to communicate is one of the leading causes for clients filing grievances against their attorney. The Colorado Supreme Court Attorney Regulation Counsel reports that out of 4,119 complaints filed against attorneys in 2008, approximately 8% (more than 320) involved claims of failure to communicate. Sanctions against attorneys for a failure to communicate can be severe.⁶⁰

⁵⁹ See, specifically, Rules 1.2(c) (limitation of the scope of representation), 1.6(a) (maintaining the confidentiality of information), 1.7(b) (conflicts of interest), 1.8(a) (business transactions with a client), 1.9 (duties to former clients), 1.18(c) (duties to prospective clients after receiving disqualifying information) and 2.3 (evaluations for the use of third parties).

⁶⁰ See Wald, *Attorney-Client Communications in Colorado*, 38 THE COLO. L. (CBA) No. 4 at 59 (Apr. 2009). The statistics were derived from note 4 to that article.

The Attorney/Client Relationship

Whether an attorney-client relationship exists is a question of fact, and the attorney-client relationship, itself, has a number of issues that must be considered. The client must be identified, and the identification of the client has certain complexities when an attorney is dealing with an organization, or individuals who want to form an entity. There are times when a person other than the client will be paying fees on behalf of the client, and those issues must be addressed. All attorneys owe their clients a specific fiduciary duty of care, and this duty even includes prospective clients in certain circumstances. Finally, attorneys must be aware of the proper procedure for declining or terminating representation. These topics are addressed individually below.

The Attorney-Client Relationship, In General.

First, it is important to note that no formal engagement letter or writing is necessary to create an attorney-client relationship.⁶¹ A putative client's reasonable, subjective belief that he is being represented by an attorney may be sufficient to give rise to the attorney-client relationship and the duties imposed by the Rules of Professional Conduct on the lawyer in such a relationship. In *People v. Bennett*,⁶² The Colorado Supreme Court held:

“An attorney-client relationship is ‘established when it is shown that the client seeks and receives the advice of the lawyer on the legal consequences of the client’s past or contemplated actions.’ The relationship may be inferred from the conduct of the parties. The proper test is a subjective one, and an important factor is whether the client believes that the relationship existed. Further, ‘[t]he attorney-client relationship is an ongoing relationship giving rise to a continuing duty to the client unless and until the client clearly understands, or reasonably should understand, that the relationship is no longer to be depended on.’” [Citations omitted]

As stated in § 14 of The Restatement of the Law Governing Lawyers, when a putative client manifests to a lawyer the person's interest that the lawyer provide legal services to the person and the lawyer fails to manifest lack of consent to do so, the lawyer-client relationship may arise.

Potential Liability to Non-Clients. This goes even further in the opinion of one panel of the Colorado court of appeals, applying the tort of negligent misrepresentation in a

⁶¹ If the attorney expects to be paid for his or her services, Rule 1.5(b) requires that the basis for compensation be communicated to the client in writing, when the attorney has not previously regularly represented the prospective client.

⁶² 810 P.2d 661 (Colo. 1991).

case where there was admittedly no attorney-client relationship. In *Steele v. Allen*,⁶³ an injured motorist consulted an attorney regarding legal options against the other driver. During the initial consultation, plaintiff claimed that the attorney advised him of an erroneous statute of limitations. The plaintiff (Steele) never retained the attorney and did not allege that an attorney-client relationship was ever established. When Steele sought advice from another attorney, the statute of limitations had expired and he lost his claim. He then sued the attorney for professional negligence and negligent misrepresentation. The district court dismissed the case on motion, but the Court of Appeals reversed, relying in part on *Mehaffy, Rider Windholz & Wilson v. Central Bank of Denver, N.A.*,⁶⁴ affirming a Court of Appeals ruling finding that attorneys could be liable to non-clients for negligent misrepresentation.⁶⁵ The Court of Appeals went on to say:

We note that the specter of potential liability to an unlimited number of third parties, which concerned the court in *Mehaffy* is alleviated by the requirement in a claim for negligent misrepresentation that the plaintiff show that the defendant supplied false information in the context of a business transaction regarding the representation of a potential client. However, informal statements by an attorney in a social setting would generally not result in a viable claim against the attorney.⁶⁶

In a 2009 case, a law firm sought a motion to dismiss a suit brought against it in a case where there allegedly existed conflicts of interest in its representation of both a lender and a borrower.⁶⁷ As alleged in the complaint, Dury loaned funds to a group of businesses (the “Trinity Entities”) which then failed to repay Dury the monies borrowed. After Dury

⁶³ 2009 WL 399992 (Colo. App. 2009), *cert granted* Mar. 22, 2010 (09SC263, 2010 WL 1011037) on the following issues:

- * Whether the court of appeals erred in imposing liability on attorneys to non-clients for negligent misrepresentation in light of *Mehaffy, Rider, Windholz & Wilson v. Cent. Bank Denver*, 892 P.2d 230 (Colo.1995).
- * Whether the court of appeals erred in relying on Restatement (Third) of the Law Governing Lawyers section 15 (2000) as a basis for establishing a duty of care on a lawyer to a non-client.

⁶⁴ 892 P.2d 230 (Colo. 1995); the Court of Appeals decision is at 865 P.2d 862 (Colo. App. 1993).

⁶⁵ 865 P.2d at 865. The Court of Appeals also cited Section 15 of the Restatement (Third) of the Law Governing Lawyers and Colo. R.P.C. 1.18 which impose certain obligations on lawyers deal with prospective clients. As stated in a commentary by Anthony Davis, the court could have reached a similar conclusion if it had reviewed the facts and concluded that the lawyer had established an attorney-client relationship and gave the client (allegedly) bad advice knowing that the client would rely on it. Compensation to the lawyer is not material to the establishment of the attorney-client relationship. Davis, *Duties to Prospective and Pro Bono Clients*, 242 N.Y. Law J. (Jul. 6, 2009) at col. 1 (© The New York Law Pub. Co.).

⁶⁶ The Court of Appeals went on to cite Restatement (Second) of Torts §552 cmt. d, and concluded, “Thus, whether statements are made during an initial consultation for legal services or in a casual manner in a social setting may ultimately be determinative of whether a lawyer is liable for negligent misrepresentation.”

⁶⁷ *Dury v. Ireland, Stapleton, Pryor & Pascoe, P.C.*, 2009 WL 2139856 (D. Colo., 7-14-2009).

filed an action against the Trinity Entities, they filed for bankruptcy protection. At the time of the initial transaction, Dury retained the law firm and attorney Miller (a partner of the firm) to draft the promissory notes and other documents. At the time, the firm was also representing the Trinity Entities and two of their founders. During the course of representing Dury, the complaint alleges that the defendant firm and attorney took positions contrary to Dury's interests and disclosed privileged information to at least one of the founders of the Trinity Entities. Dury alleged that the attorney and the firm failed to disclose the conflicts of interest to him and that, if the attorney and the firm were not acting as counsel to Dury (because they were acting as counsel to their other clients instead), they had "tortiously failed to disclose this fact to [Dury]." In denying the attorneys' motion for dismissal the District Court said (in part):

"[A]n attorney can be liable for negligent nondisclosure when he fails to exercise reasonable care or competence in communicating materially incomplete information to a non-client regarding a matter in which the attorney should reasonably foresee the non-client will rely on the incomplete information."⁶⁸

Declining and Terminating Representation; Prospective Clients.

As indicated in the *Bennett* case, once the attorney-client relationship has commenced, the question of whether the attorney-client relationship has concluded can be difficult. As quoted above, *Bennett* says clearly:

'The attorney-client relationship is an ongoing relationship giving rise to a continuing duty to the client unless and until the client clearly understands, or reasonably should understand, that the relationship is no longer to be depended on.'

Rule 1.16 – Declining or Terminating Representation. Rule 1.16 discusses when and how a lawyer may decline or terminate a representation, and what obligations flow from the termination. Generally the 2008 rule is similar to the former rule. Rule 1.16(b)(1) is a significant, positive, change for lawyers, and is equivalent to a "no fault divorce" between the lawyer and client. Former Rule 1.16 did not permit a lawyer to withdraw solely on the grounds that "withdrawal can be accomplished without material adverse effect on the interests of the client." Under new Rule 1.16, no other reason is necessary. The right to withdraw may be limited if the attorney's withdrawal may materially adversely affect the client.

Rule 1.16(d) requires that, upon termination of representation, the lawyer must take steps "to the extent reasonably practicable" to protect a client's interests. These steps may include "allowing time for employment of other counsel, surrendering papers and property

⁶⁸ Citing *Smith v. Boyett*, 908 P.2d 508, 513-14 (Colo. 1995) and *Mehaffy, Rider, Windholz & Wilson v. Central Bank Denver, N.A.*, 892 P.2d 230, 236-37 (Colo. 1995).

to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred.” The Colorado Bar Association Ethics Committee issued letter opinion 2007-2⁶⁹ which addressed the obligation of an attorney surrendering paper and property to the client. An estate planning attorney asked whether the obligation included an obligation to surrender digital files “in accessible electronic format, if so maintained,” so that the client could “save . . . money during the revision process” by new counsel. The Ethics Committee concluded that delivering electronic files “is a reasonably practical step that [the attorney] should take to enable the continued protection of your former client’s interests within the meaning of C.R.P.C. 1.16(d).”

The letter opinion leaves a number of questions unaddressed. For example, the letter opinion does not address whether an attorney can claim a lien on the client’s digital files as the attorney can on paper files. To the extent that an attorney has the right to retain paper files pursuant to an attorney’s lien for unpaid fees, the attorney should have the same right to retain digital files.⁷⁰

The letter opinion also does not address whether any portion of the digital files may be considered to be “work product” which, under Formal Opinion 104, attorneys are not obligated to turn over to clients.⁷¹ Formal Opinion 104 does not address whether (for example) special formatting of a document for printing that may have been accomplished by the attorney or his or her staff is “work product” or client’s property.⁷² Can an attorney deliver a text-readable version of the document in Adobe Acrobat format to meet the Rule 1.16(d) requirement? While all of the words are generally available in such a format, transforming the document into a word processing accessible document loses all formatting codes and requires a significant amount of “clean up” work by the successor attorney or his or her staff.

Formal Opinion 104 provides that, to the extent the attorney retains drafts in the client file, the client is entitled to receive those drafts. The same should apply to digital drafts of documents.

⁶⁹ Abstract available at 36 THE COLO. L. (CBA) No. 11 at 17 (Nov. 2007).

⁷⁰ See Formal Opinion 82, CBA Ethics Committee, April 15, 1989, addendum issued 1995, available at <http://www.cobar.org/index.cfm/ID/386/CETH/Formal-Ethics-Opinions-Index/>.

⁷¹ See Formal Opinion 104, CBA Ethics Committee, April 17, 1999, available at <http://www.cobar.org/index.cfm/ID/386/CETH/Formal-Ethics-Opinions-Index/>.

⁷² Formal Opinion 104 provides the following as an example of attorney work product which may be withheld from a client when turning over records: “Certain documents may be withheld: for example, internal memoranda concerning the client file, conflicts checks, personnel assignments, and lawyer notes reflecting personal impressions and comments relating to the business of representing the client. This information is personal attorney-work product that is not needed to protect the client’s interests, and does not constitute papers and property to which the client is entitled.” The Formal Opinion concludes with the statement that “The lawyer should err on the side of production.”

Another question for which answers are yet to be given is the ability of an attorney, before turning over documents, to scrub metadata from the documents. This would include things like revision schedules, authors working on the document, redline-strikeout codes, and other hidden information. Metadata⁷³ is a known feature of MS Word, and can only be removed by special metadata scrubbers or by converting the document to a read-only format such as Adobe. In an article addressing metadata, the author concluded that when sending documents to third parties on behalf of the client, metadata scrubbing is consistent with the attorney's duty of confidentiality under C.R.P.C. Rule 1.6(a).⁷⁴ What if the client specifically requests the attorney to leave metadata in the document? This question is not addressed by letter opinion 2007-2 or by Formal Opinion 104.

⁷³ The Southern District of New York engaged in an in depth discussion of metadata in the context of litigation in *Aguilar v. Immigration and Customs Enforcement*, 255 F.R.D. 350 (SDNY 2008). It identified three types of metadata: substantive, system and embedded:

Substantive metadata was identified as data "created as a function of the application software used to create the document or file," such as prior edits or editorial comments.

System metadata was defined as data that "reflects information created by the user or by the organization's information management system," such as data concerning author, date and time of creation and modification.

Embedded metadata was defined as consisting of "text, numbers, content, data or other information that is directly or indirectly inputted into a [n]ative [f]ile by a user and which is not typically visible to the user viewing the output display," such as spreadsheet formulae.

In *Dahl v. Bain Capital Partners, LLC*, 2009 WL 1748526 (D.Mass., 2009), the court denied plaintiffs' motion requesting the production of all metadata associated with emails and MS Word documents produced by the defendants. The court advised the plaintiffs that, instead of making "sweeping requests for metadata," such requests should be tailored to specific documents which would in turn reduce the costs and burdens associated with electronic discovery. The court denied the defendant's request to shift the costs of discovery to the plaintiffs, but said that if the plaintiffs wanted to change the data into a format other than the form maintained by the defendants, the plaintiffs would have to bear the burden of that cost.

⁷⁴ Luce, "What's the Matter With Metadata," 36 THE COLO. L. (CBA) No. 11 at 113 (Nov. 2007). Mr. Luce also concluded that metadata mining (adverse counsel retrieving and using metadata from sent documents) is permissible under the pre-2008 Colorado Rules of Professional Conduct. The District of Columbia Bar Association Legal Ethics Committee addressed this issue in its Ethics Opinion 341. The Committee noted that lawyers who send electronic documents outside of discovery or subpoena have a duty under Rule 1.6 to take reasonable steps to maintain the confidentiality of the documents, including removing potentially harmful metadata before sending the documents. This requires that the lawyers understand the software they use or they have employees who can safeguard against unintended disclosures. However, there is also a duty upon receiving lawyers who actually know that a sender has inadvertently included metadata along with a document. The opinion held that lawyer should not review the metadata without contacting the sending lawyer and abiding by the sender's instruction. This gives the sender the opportunity to determine if the metadata includes work product or confidential information of the sender's client. In all other circumstances, however, the receiving lawyer is free to review the metadata contained in electronic files provided by an adversary. See, also, Colorado Ethics Committee Formal Opinion 119 (May 17, 2008) published at 37 THE COLO. L. (CBA) No. 8 at 59 (Aug. 2008).

Colorado Rule 1.16(d) requires that, when terminating the representation of a client, a lawyer take steps necessary to protect the client's interests including (without limitation) "giving reasonable notice to the client" of the termination. Comment [1] to Rule 1.16 provides that "[o]rdinarily, representation in a matter is completed when the agreed-upon assistance has been concluded." Even then, notification under Rule 1.16(d) is required unless the termination of the representation upon conclusion of the matter at hand was clearly set forth in the engagement letter. As stated in a 1994 article⁷⁵ which is still good guidance:

"Due to the discrepancies and different standards being applied by the courts today in the determination of when the attorney-client relationship terminates, attorneys should take extra precautions to make sure that there is a clear, unambiguous end to the attorney-client relationship. Attorneys should make sure that the relationship's termination is evidenced in writing and in such a manner that neither the client nor a tribunal can question the relationship's termination."

Rule 1.18 – Prospective Clients. Rule 1.18 has no counterpart in the pre-2008 rules. This new rule prohibits an attorney using information gained from dealing with a prospective client against that person's interests – whether or not the prospective client becomes an actual client. The new rule provides an exception to the prohibition when, during the course of the interview, "the lawyer who received the information took reasonable steps to avoid disclosure to more disqualifying information." This protects the situation where the lawyer, in a client intake interview, realizes that there may be conflicts with existing clients or other interests of the attorney or the law firm. The rule goes on to require that, for the exception to be applicable, the lawyer receiving the information from the prospective client must be "screened from further participation in the matter and is apportioned no part of the fee therefrom."⁷⁶ Additionally, written notice must be given to the prospective client.

Most requirements of this rule are achievable. However, given the compensation structure of most law firms, it is likely not possible to avoid apportioning a portion of the fee from any specific representation to any specific attorney.⁷⁷ Thus the effect of this new rule

⁷⁵ Sutton, *How Long Does an Attorney-Client Relationship Last?*, Journal of the Legal Profession (1994) 277, at 287.

⁷⁶ Similarly, under Rule 1.10(e), when an attorney moves laterally to a new firm, circumstances exist where the firm can represent a client adverse to a client of the former firm even where the new lawyer had minimal involvement in the representation. This requires that the new firm take appropriate screening measures and again ensures that the new lawyer "is apportioned no part of the fee therefrom."

⁷⁷ One ethics opinion has been found under Rule 1.10 that discusses this "no apportionment requirement. State of Washington Informal Opinion 1498 (1992) distinguishes between a partner and an associate moving laterally and dealing with the 1.10 consequences:

is that a prospective client can effectively disqualify an unsuspecting law firm should the prospective client desire to do so. Attorneys must be alert to potential conflicts of interest very early in the intake process. Otherwise, this may give less reputable plaintiffs or defendants the opportunity to go “attorney shopping,” provide disqualifying information during the initial interview, and thereby prevent an attorney or firm from representing even a long-term client in adverse litigation.

Who Is the Client?

When an attorney represents a legal entity such as a corporation, limited liability company, or other entity, the attorney must identify the client at the inception of the representation. It is frequently important to reconsider the issue from time-to-time during the representation because, as noted above in *Bennett*, the attorney-client relationship can evolve and take different forms.

An entity is a legal fiction – it is a ‘person’ for legal purposes, but it cannot take any action except through the efforts of its managers, officers, members, directors, or other human beings. Frequently representation of an entity over time results in a close relationship between the attorney and certain of these human beings. The attorney must always remember that, when representing the organization these individuals are not the attorney’s client – the client is the organization.

Colo. RPC Rule 1.13 makes it clear that that the attorney for an entity “owes allegiance to the organization itself and not [to] its individual stockholders, directors, officers, employees, representatives or other persons connected with the entity.” Rule 1.13 of the ABA’s Model Rules of Professional Conduct is identical.

While Rule 1.13 makes it clear that the attorney must recognize the entity as his or her client, Rule 1.13 does not prevent the attorney-client relationship from evolving to include constituents, as well. This can happen when the attorney is not careful, or it may occur intentionally. During the representation, the relationship may evolve and the entity’s constituent (officer, director, or other) may “seek[] and receive[] the advice of the lawyer on

“The Committee was of the opinion that a personally disqualified associate may be paid a regular salary, but may not share in any bonus or any other additional payment based upon the fee received in the case from which he or she is screened.”

“The Committee was of the opinion that in the case of a personally disqualified partner, the law firm must put into place an accounting practice to ensure that the gross income received from the case is handled in such a way that the personally disqualified partner does not share in it in any way. The Committee was further of the opinion that the law firm must document that accounting because the rule places the burden of proof of compliance upon the law firm.”

Surprisingly, this point and the mechanics of accomplishing this “non-apportionment” requirement are not discussed in the comments to Rule 1.10 or Rule 1.18.

the legal consequences of the client's past or contemplated actions." As the court in *Bennett* said, this is a subjective analysis and depends in large part upon the belief of the putative client.

The client may intentionally evolve. For example, during a merger or acquisition transaction, an attorney for the target may also be representing the officers in negotiating employment contracts. Conflicts of interest rules under Colo. RPC 1.7 must be considered, but this may be a waivable conflict. Of course, the tougher the attorney is in negotiating the employment contract (or other economic terms outside of the target's interest), the less value may remain for the target and its equity holders. Thus, depending on the facts and circumstances, the conflict may not be waivable.

Thus, the attorney must make clear to all relevant parties, not only at the commencement of the representation but during the progress of the representation, where the attorney-client relationship lies.

When a dispute develops that involves the entity and certain of its constituents, the attorney for the entity must be on a heightened awareness. Formal Opinion 120⁷⁸ reiterates Rule 1.13 that the attorney representing the organization owes his or her duties to the organization. The Formal Opinion goes on to provide that representing the organization does not necessarily mean that the attorney is also representing any of the constituents (stockholders, members, officer, directors, or managers). Consequently, the attorney representing the organization cannot assert that he or she is also representing any constituent unless the attorney reasonably believes that he or she has been retained to represent the constituent. "Knowingly making such an assertion without having [such] a reasonable belief . . . would violate Rule 4.1 on truthfulness in statements to others."

Formal Opinion 120 goes on to discuss the situation where the interests of the organization are potentially adverse to the interests of its constituents. In that case, the attorney must clarify his or her role and advise the constituents that the attorney-client relationship flows to the organization and that the constituent may want to obtain independent representation. The other consequence is that there would not be confidentiality or attorney-client privilege in communications between the attorney and the constituent.

Finally, Formal Opinion 120 reminds attorneys that, under Rule 3.4(f), an attorney is prohibited from requesting that a person (other than a client) refrain from providing non-privileged information to another party except where both: (1) the person is a relative or employee or other agent of the client and the lawyer is not prohibited by other law from making the request **and** (2) the lawyer reasonably believes the person's interest will not be adversely affected by refraining from giving such information.

⁷⁸ Colorado Bar Association Ethics Committee, adopted May 17, 2008 (published at 37 THE COLO. L. (CBA) No 8 at 62 (Aug. 2008)).

Forming an Entity – Who Is the Client?

During the pre-formation period, the attorney is working with individuals to form an entity. If the entity will be the ultimate client, the lawyer must recognize that the entity does not yet exist. But the lawyer must make it clear to the individuals that none of them is individually, his client. The Colorado rules do contemplate this representation, but the attorney must recognize, and must advise his or her clients, that there are significant potential conflicts of interest in almost any entity formation. As only a single example, when the clients are valuing their respective contributions to the entity, each time a share or percentage is issued to one person, that share or percentage is not available to another. There are many more subtle decisions that must be made in the formation of an entity, the drafting of a buy-sell or other agreement among the equity holders, and in the continuing representation where one decision may favor one of the constituents and disadvantage another. Thus the issues discussed below surrounding 1.7 (conflicts of interest) and 4.3 (dealing with unrepresented persons) must be considered (among others). In considering these issues, note Comments [8] and [28] to Rule 1.7:

“[8] . . . For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer’s ability to recommend or advocate all possible positions that each might take because of the lawyer’s duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer’s independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of [one of the clients].”

“[28] Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties’ mutual interests. Otherwise each party might have to obtain separate representation, with the possibility of incurring additional cost, complication, or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.”

While it may be the clients' preference that the lawyer acts for all of them, the lawyer would frequently be better served by identifying and acting for a single client, even if it may be the entity that does not yet exist. In any event, the attorney must advise the individuals involved as to the attorney-client relationship with the recommendation (in writing) that each of the individuals consult with their own attorney if they determine it to be necessary or appropriate in the circumstances.⁷⁹

The Arizona State Bar has expressed the opinion that it is permissible for a lawyer to represent an entity that does not yet exist:

As long as the incorporators understand that they are retaining counsel on behalf of the yet-to-be-formed entity and will need to ratify this corporate action, *nunc pro tunc*, once the entity is formed.⁸⁰

The Arizona Opinion goes on to say that it is the lawyer's duty to clarify at the outset whom the lawyer represents.

Colo. RPC 4.3 (effective January 1, 2008) permits a lawyer to give legal advice to an unrepresented person so long as the lawyer does not know (and has no reason to know) of a conflict between the interests of the lawyer's client and the unrepresented person. Paragraph [2] of the Comment explains the reasons for this expansion of the lawyer's permissible communications with unrepresented persons:

[2] The Rule distinguishes between situations involving unrepresented persons whose interests may be adverse to those of the lawyer's client and those in which the person's interests are not in conflict with the client's. In the former situation, the possibility that the lawyer will compromise the unrepresented person's interests is so great that the Rule prohibits the giving of any advice, apart from the advice to obtain counsel.

This protects a lawyer when, for example, the lawyer is meeting with several individuals about the formation of a new business. Depending on the identification of the lawyer's client in such a circumstance, all of the other parties at the meeting are technically unrepresented. However, where the parties are all pursuing the same goal on an amicable basis, little purpose can be served by advising everyone else at the table to "obtain your own counsel." This is a beneficial clarification under the 2008 rules. Other states have reached a

⁷⁹ See Colo. RPC 4.3, Dealing with Unrepresented Persons.

⁸⁰ Ariz. Opinion No. 02-06 at 3 (Sept. 2003).

similar conclusion, although in some cases using a retroactive application of the entity rule⁸¹ to do so.

The engagement letter for the representation is usually the first time the attorney has to clarification the focus of the representation and to identify the client. When drafting any further agreement that defines the relationship among the unrepresented persons and the represented entity it is important to be clear that each unrepresented person should consult with his or her own legal advisors if they determine it to be necessary. It is not the attorney's choice whether such consultation is necessary – it is a decision that should be made by the unrepresented person, whether a member or manager of the LLC, partner of a partnership, or an officer, shareholder, or director of a corporation.⁸²

⁸¹ The entity rule, which derives from CRPC Rule 1.13, holds that the lawyer represents the entity, not the individual constituents. *See, for example, Jesse v. Danforth*, 485 N.W.2d 63 (Wis. 1992), which offered the following guideline:

[W]here (1) a person retains a lawyer for the purpose of organizing an entity and (2) the lawyer's involvement with that person is directly related to that incorporation and (3) such entity is eventually incorporated, the entity rule applies retroactively such that the lawyer's pre-incorporation involvement with the person is deemed to be representation of the entity, not the person.

See also Manion v. Nagin, 394 F.3d 1062 (8th Cir. 2005). *See also McKinney v. McMeans*, 147 F.Supp.2d 898 (W.D. Tenn. 2001) (following *Jesse*, denying motion to disqualify plaintiff's attorney, who prepared shareholder agreement, represented the corporation, then filed suit on behalf of one shareholder against the other); *In re Ireland*, 706 P.2d 352 (Ariz. 1985) (disciplining lawyer for conflict of interest for failing to disclose to corporation one incorporator's improper use of funds, where evidence showed that lawyer represented corporation in formation and operation); B. Wunnicke, *Ethics Compliance for Business Lawyers* §§ 8.4 and 8.5 (1987) ("The appealing reality is that often the lawyer who is organizing a corporation is representing the group.") (*quoted with approval in Meyer v. Mulligan*, 889 P.2d 509, 514 (Wyo. 1995)); "An Expectations Approach to Client Identity," 106 *Harv. L. Rev.* 687, 691, 696 (Jan. 1993) (*Jesse* comports with the "reasonable constituent's expectation approach"; "Treating pre-incorporation individual representation, absent evidence to the contrary, as entity representation accords with an organizer's reasonable expectations during the incorporation phase of the company's existence."); T. Thompson, "What is an Entity? – Entity-in-Formation," 6 *Ariz. Prac. Corporate Practice* § 2.5 (2004 ed.) (*citing Jesse* for proposition that treatment of entity-in-formation as person capable of being a client has become "well settled").

⁸² For example, see the following disclaimer published in Lidstone, "Form of Stock Redemption and Cross Purchase Agreement" (ch. 23) in Rozansky and Reichert, PRACTITIONER'S GUIDE TO COLORADO BUSINESS ORGANIZATIONS (Colorado Bar Assn. 2007)

Section 15.6. Professional Advisors. The Parties understand, acknowledge, and agree that the law firm of _____, P.C. represents only the Company with respect to this Agreement and has offered no legal, tax, or other advice to any Stockholder. The Stockholders further acknowledge and agree that: They have been advised to retain independent legal, tax, and accounting advice of their own choosing for purposes of representing their individual interests with respect to the subject matter hereof; They have been given reasonable time and opportunity to obtain such advice; and They have obtained such independent advice as they have deemed necessary and appropriate in the circumstances.

Who Is Paying the Fees?

In some cases, a person other than the named client may be paying the client's fees – such as when a promoter is paying the legal fees of a corporation or when the acquirer is paying the fees of the target who may not otherwise be able to afford the necessary legal representation. In any case where a person other than the client is paying legal fees, the attorney must consider the requirements of Rule 1.8(f) of the Colorado and Model Rules of Professional Conduct:

A lawyer shall not accept compensation for representing a client from one other than the client unless: (1) the client consents after consultation; (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and (3) information relating to representation of a client is protected as required by Rule 1.6.

Once again, it is advisable for the attorney to make all necessary disclosures in writing and obtain the client's informed consent.⁸³

Duty of Care.

An attorney owes a duty of care to each client,⁸⁴ and (under cases like *Steele v. Allen* and *Dury* discussed above⁸⁵), potentially to non-clients as well. The duty of care requires that an attorney act with reasonable diligence and promptness in attending to the client's needs notwithstanding "opposition, obstruction, or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor."⁸⁶ An attorney must employ that degree of knowledge, skill, and judgment

⁸³ Colo. RPC 1.0(e) defines informed consent to be the person's "agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." The attorney may confirm the consent in a letter to the person, or may obtain the person's signature on a communication, such as an engagement letter. Rule 1.4 (Communication) requires that the lawyer, as a part of his or her duty to communicate with the client, fully inform the client about matters requiring the client's "informed consent."

⁸⁴ Restatement of the Law Governing Lawyers § 483, cmt. e. *Miller v. Byrne*, 916 P.2d 566, 579 (Colo. Ct.App. 1995). Generally, a fiduciary duty arises between individuals through a relationship where one party is empowered with a high level of control, trust, confidence or reliance. *Bailey v. Allstate Ins. Co.*, 844 P.2d 1336, 1339 (Colo. Ct.App. 1992). Certain relationships give rise to fiduciary duties as a matter of law. *Id.* Due to the high degree of control, level of trust and level of confidence empowered to an attorney, the attorney-client relationship gives rise to fiduciary obligations as a matter of law. *See Id.*; Restatement of the Law Governing Lawyers § 49. Legal malpractice actions based on breach of fiduciary duty involve violations of standards of conduct. *Smith v. Mehaffy*, 30 P.3d 727 (Colo. Ct.App. 2000). In order to establish a breach of a fiduciary duty, the plaintiff must demonstrate "that [1] the plaintiff incurred damages, and [2] that the [attorney's] breach of fiduciary duty was the cause of the damages sustained." *Miller*, 916 P.2d at 575.

⁸⁵ *See* Section 8.3.1.

⁸⁶ Colo. RPC 1.3, comment [1].

ordinarily possessed by members of the legal profession at the time the task is undertaken.⁸⁷ Although required to act with “commitment and dedication to the interests of the client and with zeal in advocacy,” the “lawyer is not bound to press for every advantage that might be realized for a client.”⁸⁸ If a dispute arises, the trier of fact determines whether the attorney has breached any duty.⁸⁹

The duty of care requires an attorney to “protect a client in every possible way.”⁹⁰ In *O’Melveny*, the court denied summary judgment in favor of a law firm because a triable issue of fact existed as to why the law firm failed to provide accurate opinion letters for two private offerings. The court explained that within the context of the private offerings, the law firm had a duty to make a “reasonable, independent investigation.” The court also noted an expert witness’ testimony arguing that the law firm’s failure to contact their client’s former counsel and accountants was a breach of the duty of due care. The plaintiff, the Federal Deposit Insurance Corporation, did not allege that the law firm had been aware of the fraud nor did the court’s conclusion rest on the law firm’s awareness of the fraud. The court in *O’Melveny* set forth that an attorney fulfills the duty of due care by performing with “such skill, prudence, and diligence as attorneys of ordinary skill and capacity commonly possess.”⁹¹

An important aspect of the Rules of Professional Conduct is their availability to private litigants. The Rules of Professional Conduct are primarily directed toward attorney conduct and disciplinary matters before the state organization (Supreme Court or other appropriate body) that regulates discipline of lawyers.⁹² The Colorado commentary states

⁸⁷ *McCafferty v. Musat*, 817 P.2d 1039, 1043-44 (Colo. App. 1990) (finding professional negligence where an attorney recommended settling a case before performing any discovery); *See also* Restatement of the Law Governing Lawyers § 52.

⁸⁸ Colo. RPC 1.3, comment [1]. The comment provides, as an example, that the lawyer may have authority to exercise professional discretion in determining the means by which a matter should be pursued.” Also, the “lawyer’s duty to act with reasonable diligence does not require the use of offensive tactics or preclude the treating of all persons involved in the legal process with courtesy and respect.”

⁸⁹ *McCafferty*, 817 P.2d at 1044.

⁹⁰ *FDIC v. O’Melveny & Meyers*, 969 F.2d 744, 748 (9th Cir. 1992), rev’d on other grounds *O’Melveny & Myers v. FDIC*, 114 S.Ct. 2048 (1994) (quoting *Day v. Rosenthal*, 170 Cal App. 3d 1125, 1143 (1985)).

⁹¹ *Id.* at 748 (quoting *Lucas v. Harem*, 15 Cal.2d 583, 591 (1961)). *Temple Hoyne Buell Foundation v. Holland & Hart*, 851 P.2d 192, 198 (Colo. Ct. App. 1992).

⁹² *See Astarte, Inc. v. Pac. Indus. Sys., Inc.*, 865 F. Supp. 693 (D. Colo. 1994) stating that under Colorado law, ethics codes for lawyers neither prescribe civil liability standards nor create private causes of action. *See* other cases cited in the *Annotated Model Rules of Professional Conduct* (Fifth Ed.) (Center for Professional Responsibility, American Bar Association, at pages 6-7).

that “[v]iolation of a Rule should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached.”⁹³ However, most courts permit the use of the applicable rules of professional conduct as evidence of the lawyer’s standard of care in cases involving malpractice and breach of fiduciary duty.⁹⁴ The Colorado commentary goes on to say that, “since the Rules do establish standards of conduct by lawyers, in appropriate cases a lawyer’s violation of a Rule may be evidence of breach of the applicable standard of conduct.”⁹⁵

What If You Have More Than One Client? The advice above clearly recommends that the attorney, in forming an entity or taking on other legal representation, clearly identify a single client so that the focus of the attorney’s duties is clearly identified. Notwithstanding that advice, there is no prohibition against an attorney representing multiple clients in the same transaction providing the rules are met. In fact, Formal Opinion 68⁹⁶ specifically contemplates that in some cases an attorney’s representation of more than a single party may be appropriate. The syllabus to the Opinion clearly lays out the issues [*emphasis supplied*]:

While attorneys are frequently requested to act as the attorney for multiple parties in drafting an agreement, *the Committee does not recommend multiple representation* because this situation places an attorney in the clearest of conflicts regarding client confidentiality and the ability to exercise professional judgment free of compromising influences. In those situations in which an attorney agrees to accept such a role, the attorney may do so only after fully disclosing the risks of multiple representation and obtaining the consent of each party. Furthermore, prior to accepting employment, the attorney must determine if it is obvious whether the attorney can adequately represent the interests of each party to the transaction. The nature of the disclosure required and the ability adequately to represent each party will depend on the agreement in question. However, regardless of the agreement in question, representing both parties requires adherence to the full range of duties

⁹³ Preamble and Scope to the Colorado Rules of Professional Conduct, Comment [20], first sentence.

⁹⁴ See cases cited in the *Annotated Model Rules of Professional Conduct* (Fifth Ed.) (Center for Professional Responsibility, American Bar Association, at pages 7-8).

⁹⁵ Preamble and Scope to the Colorado Rules of Professional Conduct, Comment [20], last sentence. Some courts take a more cautious approach, permitting ethics rules to be considered in cases to the extent an expert witness has used them in reaching a conclusion in the case regarding legal malpractice, and a small number of courts do not permit the use of the rules to show evidence of malpractice. See *Annotated Model Rules of Professional Conduct* (Fifth Ed.) (Center for Professional Responsibility, American Bar Association, and cases cited therein at page 8-9).

⁹⁶ *Conflicts Of Interest: Propriety Of Multiple Representation*, Adopted April 20, 1985.

accompanying the attorney-client relationship and *under no circumstances is multiple representation to be considered a “scrivener’s” role.*

The Formal Opinion goes on to describe certain disclosure that must be made to the clients, including that there is no attorney-client privilege as between the clients – information conveyed by one of the multiple clients can (and perhaps should) be conveyed to all of the clients involved in that representation. If subsequent litigation between the multiple clients develop, “the privilege will not protect any communications between the attorney and each party.”

Formal Opinion 68 goes on to provide that, in the event a dispute among or between the clients does develop, the attorney will have to withdraw from representing any of the parties absent knowing consent of both sides and the attorney’s determination that he or she can continue the representation of one party against the other party without violating any of the Rules. The attorney must disclose to the client that the net effect of such a withdrawal is that each party will likely incur higher legal costs than if separate counsel had been secured at the outset of the transaction.

In all but the most unusual cases, it is preferable for the attorney to have a single client.

Rule 1.1 Competence

As should be obvious to all practicing lawyers, competence in the practice of law flows through all of the other rules.

Rule 1.1 is specifically mentioned in Formal Opinion 119, *Disclosure, Review, and Use of Metadata*,⁹⁷ which addresses the ethical obligations of the “sending lawyer” who transmits electronic documents containing metadata to a third party, including the lawyer for an adverse party. According to Opinion 119, any lawyer (or staff person) who transmits electronic documents or files has a duty to use reasonable care to guard against the disclosure of metadata containing confidential information. The definition of reasonable care will depend on the facts and circumstances of each case. Opinion 119 makes it clear that the duty under Rule 1.1 to provide competent representation requires each lawyer sending electronic information “to ensure that he or she is reasonably informed about the types of metadata that may be included in an electronic document or file and the steps that can be taken to remove metadata if necessary.”

Rule 2.3 permits a lawyer for a client to provide an evaluation for the use of a third party. As discussed below, this is usually the situation with legal opinions. In order to

⁹⁷ Ethics Committee, Colorado Bar Association, Formal Opinion 120 (May 17, 2008) available at <http://www.cobar.org/index.cfm/ID/386/subID/23920/CETH/>.

competently render a legal opinion for the benefit of a client, the opining lawyer must be familiar with customary practice as defined in the literature and elsewhere.⁹⁸

Rules 1.2(d), Rule 4.1 and 8.4(c) – Truthfulness in Statements to Others

Rule 4.1 requires that lawyers be truthful in their statements to others. Under Rule 1.2(d), a lawyer is prohibited from counseling or assisting a client in conduct that the lawyer knows is criminal or fraudulent. Rule 8.4(c) provides that it is professional misconduct to engage in conduct involving dishonesty, fraud, deceit or misrepresentation. While Rules 4.1 and 1.2(d) involve client representation, Rule 8.4(c) expands the lawyer's obligation for truthfulness to all aspects of the attorney's practice and life, including social networking sites.

Rule 4.1(b) addresses the situation where a client's crime or fraud takes the form of a lie or misrepresentation. These rules have significant potential applicability to lawyers practicing transactional law.

According to the commentary to Rule 4.1, a lawyer can ordinarily avoid assisting a client's crime or fraud by withdrawing from the representation. Sometimes it may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm an opinion, document, affirmation or the like. In extreme cases, substantive law may require a lawyer to disclose information relating to the representation to avoid being deemed to have assisted the client's crime or fraud. If the lawyer can avoid assisting a client's crime or fraud only by disclosing this information, then under Rule 4.1(b) the lawyer is required to do so, unless the disclosure is prohibited by Rule 1.6.

Even apart from ethical obligations, assisting client's misdeeds may lead to civil, criminal, or administrative liability to attorneys. In *Thompson v. Paul*,⁹⁹ the Ninth Circuit surveyed case law from the Third, Fifth, Sixth, and Seventh Circuits seeking to hold attorneys liable for actions of their client in the context of securities representation. The Ninth Circuit found that a clear rule emerges:

⁹⁸ This literature is easily available and much of it can be found in the ABA's legal opinion resource center. <http://www.abanet.org/buslaw/tribar/home.shtml>. The website of the American College of Real Estate Lawyers (www.acrel.org) includes valuable information for persons writing legal opinions in real estate transactions. Of these, the ABA's "Guidelines for the Preparation of Legal Opinions," 57 The Bus. L. (ABA) 875 (2002) and "Legal Opinion Principles," 53 The Bus. L. (ABA) 831 (1998), are among the most significant, as are the reports prepared by the TriBar Opinion Committee. There are also numerous treatises available, including contributions from a number of Colorado lawyers in Holderness and Wunnicke, *Legal Opinion Letters Form Book* (Aspen Law Business, 2nd Ed. 2003). Chapter 1B of the 2008 Supplement is a primer for lawyers not experienced in opinion practice. *Glazer and Fitzgibbon on Legal Opinions: Drafting, Interpreting, and Supporting Closing Opinions in business Transactions* (Aspen Law & Business, 3rd Ed.) is another valuable resource for legal opinion preparers.

⁹⁹ 547 F.3d 1005 (9th Cir. 2008).

An attorney who undertakes to make representations to prospective purchasers of securities is under an obligation, imposed by Section 10(b), to tell the truth about those securities. That he or she may have an attorney-client relationship with the seller of the securities is irrelevant under Section 10(b).¹⁰⁰

The *Thompson v. Paul* case posits liability for the attorneys as a primary participant in the fraud, as required by the U.S. Supreme Court in its *Stoneridge* decision.¹⁰¹ According to the pleadings in *Stoneridge*, in 2000 Charter Communications, Inc., was facing a significant revenue and cash flow shortfall as compared to Wall Street expectations. Charter allegedly agreed to overpay Scientific-Atlanta, Inc. and Motorola, Inc. by a total of \$17 million for set-top boxes that Charter had already agreed to purchase from them at lower prices. Allegedly, *quid-pro-quo* for the overpayment, Scientific-Atlanta and Motorola agreed to use those additional funds to purchase unwanted advertising from Charter. To create an appearance that these transactions were legitimate, Scientific-Atlanta and Motorola each allegedly: (i) issued documentation stating that they demanded the price increases because of higher costs; (ii) backdated contracts; and (iii) agreed to “purchase” advertising at four to five times regular rates using Charter’s overpayment. The factual allegations in *Credit Suisse* and *Simpson* were equally egregious. Documents were presented in each of the cases that indicated that the secondary actors (Scientific Atlanta and Motorola in the *Stoneridge* case) knew that their transactions would be used by the primary actor (Charter in the *Stoneridge* case) to inflate their financial statements. Thus, in none of these cases were the secondary actors innocent dupes.

However, in no case did the secondary actors make any public disclosures or representations that were then included in public disclosures. In no case were the secondary actors involved in the offer, purchase, or sale of securities as required in *Blue Chip Stamps v. Manor Drug Stores*.¹⁰² And in no case did the secondary actors have a legal duty to speak.

¹⁰⁰ Notably it is also irrelevant under the Rules of Professional Conduct that governs lawyers in all 50 states. Rule 2.3 of the ABA’s Model Rules (adopted in most states) is entitled “*Truthfulness in Statements to Others*.” An attorney assisting a client in a crime or fraud, including a violation of SEC Rule 10b-5, is also breaching his or her ethical obligations. When the attorney speaks to third parties, the attorney has a duty to speak truthfully. It is preferable not to speak at all when there is any doubt.

¹⁰¹ During 2007, there were three similar cases pending before the Supreme Court which again rose the question of potential liability for secondary actors under Rule 10b-5. This was initially resolved in 1994 in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), but resuscitated in the early 21st century in the cases of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted*; *Regents of the University of California, et al. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *cert. granted* and *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), *cert. granted*. In each of those three cases, third parties assisted public companies in inflating revenue and profits by engaging in the “round-trip transactions” similar to the *Stoneridge* transaction described in the text.

¹⁰² 421 U.S. 723 (1975). See Lidstone, *Securities Law Deskbook* (www.bradfordpublishing.com) at § 16.4.1.

As the Supreme Court said in *Chiarella v. United States*,¹⁰³ “When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.” The Supreme Court issued its *Stoneridge* decision on January 15, 2008,¹⁰⁴ holding:

Here respondents were acting in concert with Charter in the ordinary course as suppliers and, as matters then evolved in the not so ordinary course, as customers. Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere. Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements. In these circumstances the investors cannot be said to have relied upon any of respondents’ deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action. This conclusion is consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.

The Supreme Court went on to say that, in the *Stoneridge* case, “any deceptive statement or act respondents made was not actionable because it did not have the requisite proximate relation to the investors’ harm. That conclusion is consistent with our own determination that respondents’ acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents.” Falsifying documents and other actions can be deceptive. In the future and similar to the cases (such as *Thompson v. Paul*¹⁰⁵) holding attorneys civilly liable for their client’s misrepresentations, cases will instead turn on whether the deceptive act was somehow communicated to the investing public and whether proximate cause exists.¹⁰⁶

Importantly, the limitations imposed by *Central Bank* and *Stoneridge* on liability for aiding and abetting securities fraud do not apply to enforcement actions brought by the SEC or actions for criminal violations brought by the United States Attorneys under § 17(a) of the Securities Act of 1933 or under Rule 10b-5 adopted under the Securities Exchange Act of 1934. As the U.S. Supreme Court stated in the *Stoneridge* case:¹⁰⁷

¹⁰³ 445 U.S. 222, 234 (1980).

¹⁰⁴ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S.Ct. 761 (2008).

¹⁰⁵ 547 F.3d 1055, (9th Cir. 2008).

¹⁰⁶ For a more detailed discussion, see Lidstone, *The Securities Law Deskbook* (www.bradfordpublishing.com) at § 16.11.

¹⁰⁷ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) at Part IV, 128 S.Ct. at 773-4.

Secondary actors are subject to criminal penalties, see, *e.g.*, [15 U. S. C. §78ff](#), and civil enforcement by the SEC, see, *e.g.*, §78t(e). The enforcement power is not toothless. Since September 30, 2002, SEC enforcement actions have collected over \$10 billion in disgorgement and penalties, much of it for distribution to injured investors. And in this case both parties agree that criminal penalties are a strong deterrent. In addition some state securities laws permit state authorities to seek fines and restitution from aiders and abettors. All secondary actors, furthermore, are not necessarily immune from private suit. The securities statutes provide an express private right of action against accountants and underwriters in certain circumstances, see [15 U. S. C. §77k](#), and the implied right of action in §10(b) continues to cover secondary actors who commit primary violations.

The conclusion must be that lawyers may be liable to third parties as a result of their client's actions. This liability may be civil, to third parties, where the third parties can show that the lawyer's actions rose to that of a primary participant in the matter. The lawyer may be liable for aiding and abetting a client's actions in enforcement or criminal actions brought to enforce the securities laws. A lawyer who follows his or her obligations under the Rules of Professional Conduct not only acts ethically, but is most likely to avoid additional liability as well.

Rule 1.5 – Fees and Fee Agreements Can an Attorney Take Equity as an Investment or for Fees

Fees and Fee Agreements. Colorado Rule 1.5 governs fees and retainer agreements. Fees must be reasonable (Rule 1.5(a)) and, except where the attorney has regularly represented the client, the fees must be communicated to the client in writing (Rule 1.5(b)). “Attorney fees are always subject to refund if they are excessive or unearned.”¹⁰⁸

Referral fees (Rule 1.5(e)) are prohibited; a division of fees among or between lawyers is permitted only to the extent permitted in Rule 1.5(d) that:

- (i) the lawyers among whom the fees are to be divided actually performed work or each of the lawyers assume the obligations of joint representation,
- (ii) the client agrees to the arrangement, including the basis on which fees are to be divided,
- (iii) the overall fee is reasonable.

¹⁰⁸

In the Matter of Larry D. Sather, 3 P.3d 403 at 413 (Colo. 2000).

The division of fees among lawyers is another case where the rules specifically require the client's consent to be in writing.

Rule 1.5(f) is extremely important – fees are not earned until the work has been performed. By the same token, non-refundable fees are prohibited in Rule 1.5(g). After the completion of the work, a lawyer is required to return any unearned fee to the client. (Rule 1.16(d).)¹⁰⁹ All unearned fees must be maintained in a COLTAF account meeting the requirements of Rule 1.15, or in a separate account where the interest on funds deposited accrues for the benefit of the client. Note that Rule 1.15 makes it clear that COLTAF accounts are intended for funds that will not generate significant income. COLTAF accounts are “pooled interest-bearing insured depository account[s] for funds of clients or third persons *that are nominal in amount or are expected to be held for a short period of time . . .*”¹¹⁰

While the rules only mandate a written fee agreement in certain circumstances (such as with a new client (Rule 1.5(b)), a contingent fee arrangement (Rule 1.5(c)), and where there will be a division of fees (Rule 1.5(d)), the commentary states the following:

“In a new client-lawyer relationship, the basis or rate of the fee must be promptly communicated in writing to the client. When the lawyer has regularly represented a client, they ordinarily will have reached an understanding concerning the basis or rate of the fee; but, when there has been a change from their previous understanding, the basis or rate of the fee should be promptly communicated in writing. All contingent fee arrangements must be in writing, regardless of whether the client-lawyer relationship is new or established. See C.R.C.P., Ch. 23.3, Rule 1. A written communication must disclose the basis or rate of the lawyer's fees, but it need not take the form of a formal engagement letter or agreement, and it need not be signed by the client. Moreover, it is not necessary to recite all the factors that underlie the basis of the fee, but only those that are directly involved in its computation. It is sufficient, for example, to state that the basic rate is an hourly charge or a fixed amount or an estimated amount, to identify the factors that may be taken into account in finally fixing the fee, or to furnish the client with a simple memorandum or the lawyer's customary fee schedule. When developments occur during the representation that render an earlier disclosure substantially inaccurate, a revised written disclosure should be provided to the client.

“A written statement concerning the fee reduces the possibility of misunderstanding. Lawyers are well-advised to use written disclosures even when they are not required. Moreover, it is preferable, although not mandatory, to obtain the client's signature acknowledging the basis or rate of the fee.”

¹⁰⁹ See *In the Matter of Larry D. Sather*, 3 P.3d 403 at 413 (Colo. 2000).

¹¹⁰ CRPC, Rule 1.15(h)(2). Emphasis supplied.

Interest on amounts that are past-due can only be assessed if the client has agreed to interest in writing. The failure to have a fee agreement in place to define the relationship between the attorney and his or her client has resulted in disciplinary actions against the attorney. In *People v. Ungar*,¹¹¹ the presiding disciplinary judge described the matter that led to a conditional admission of misconduct and a 90-day suspension as follows:

“Respondent performed securities work on behalf of his client, an investment company, in connection with the acquisition of controlling interests in shell companies that were to become the subject of reverse mergers. However, Respondent failed to communicate the basis of his fee in writing to his client and never explicitly agreed on the contingencies of the fee agreement. A dispute as to the funds held by the Respondent in escrow later arose when he failed to keep all of the funds subject to this transaction in trust [as required by C.R.P.C. Rule 1.15].”

A carefully-worded fee agreement would have resolved that issue and many other similar disputes that arise with clients.

Can an Attorney Take Equity in a Client as an Investment or as Payment of Fees? Under the Rule 1.5(a) of the Colorado Rules of Professional Conduct, attorney’s fees must be reasonable. Where the fees are negotiated between sophisticated business people and their counsel in a normal business representation, the fees are generally presumed to be reasonable.

In many cases, clients ask attorneys to invest in a corporate or partnership entity. This is specifically contemplated and permitted in the comment to Rule 1.5, as follows:

“A lawyer may accept property in payment for services, such as an ownership interest in an enterprise, providing this does not involve acquisition of a proprietary interest in the cause of action or subject matter of the litigation contrary to Rule 1.8(j). However, a fee paid in property instead of money may be subject to special scrutiny because it involves questions concerning both the value of the services and the lawyer’s special knowledge of the value of the property.”

There are many reasons a client may request the attorney to accept payment of fees, at least in part by accepting an ownership interest –

- perhaps as a method of reducing fees payable to the attorney, or

¹¹¹ 05PDJ076 (Colo. PDJ, Jun. 8, 2006) available at <http://www.coloradosupremecourt.com/PDJ/ConditionalAdmissions/Ungar.Conditional%20Admission,05PDJ076,%2006-08-06.pdf>.

- perhaps as a method of having the attorney show confidence in the client and his or her business.

Many attorneys have accepted investment opportunities in clients. One of the principal limitations is found in malpractice insurance policies maintained by attorneys. Generally these policies contain limitations on the percentage investment an attorney can make, or at least require disclosure of instances where the covered attorney has invested in a client. The 1998 report of the ABA's Business Law Section's Committee on Business Ethics warns that:

“even when precautions are taken, lawyers still risk accusations of self-dealing. The lawyer who goes into business with a client faces a heavy burden of establishing both informed consent and transactional fairness.”

A commentator suggests that attorneys who invest in clients “not only have the opportunity to become a multi-millionaire, you have the opportunity to get sued.”¹¹² The ethical rules do not prohibit an attorney from investing in a client or from taking an equity interest in the client in lieu of, or in addition to, fees. For example, ABA Formal Opinion 00-418 states in pertinent part:

“The Model Rules of Professional Conduct do not prohibit a lawyer from acquiring an ownership interest in a client, (i) either in lieu of a cash fee for providing legal services or (ii) as an investment opportunity in connection with such services, as long as the lawyer complies with Rule 1.8(a) governing business transactions with clients.”¹¹³

Colorado has issued a formal opinion on the subject – Formal Opinion 109.¹¹⁴ The Formal Opinion warns (with citations included):

“The circumstances of each case should be judged under an objective standard of reasonableness. *See* Colo. RPC 1.5(a); *Feiger, Collison & Killmer v. Jones*, 926 P.2d 1244, 1252 (Colo. 1996) (client's sophistication a factor); *Beeson v. Industrial Claim Appeals Office of the State of Colorado*, 942 P.2d 1314, 1316 (Colo. App. 1997) (various factors should be employed to measure the reasonableness of the attorney fee, and the weight given to any factor depends on the circumstances of each case.) A lawyer taking equity in lieu of fees would be well advised to obtain, if possible, an objective valuation of the equity interest at the time it is received to demonstrate that

¹¹² Debra Baker, *Who Wants to be a Millionaire?*, 86 A.B.A.J. 36, 38 (Feb. 2000).

¹¹³ *Accord* Association of the Bar of the City of New York Committee on Professional and Judicial Ethics, Formal Opinion 2000-3.

¹¹⁴ “Acquiring an Ownership Interest in a Client,” May 19, 2001.

the fee is reasonable in light of the benefit conferred or services rendered or to be rendered to the client in return.”

The Formal Opinion goes on to note that the receipt of an ownership interest in a client in lieu of fees is (when paid at the commencement of the representation) equivalent to an advance against fees. The requirements of Rule 1.15 (for holding advance fees in a COLTAF account) and 1.16(d) (for the returning of fees) must be considered when accepting an ownership interest in lieu of cash payment of fees.

Issues arise under the rules even where an attorney invests in a client rather than accepting an ownership interest in lieu of cash payment of fees. In either case, it is considered to be a “business transaction with a client,” and must comply with the requirements of Rule 1.8(a) discussed below. In considering taking equity for fees or investing in a client, it is important to note that, “although it has been said that ‘there are no transactions that courts will scrutinize with more jealousy than dealings between and attorney and his client,’¹¹⁵ neither the common law nor rules of professional ethics prohibit such transactions outright.”¹¹⁶ Where the attorney is receiving equity as a portion of the fee being charged for the legal services in question, the attorney must evaluate whether the fee is excessive. This must be evaluated as of the time the transaction is negotiated.

In providing legal services to the client’s business while owning its stock, an attorney must be cognizant of the limitations under various other Rules of Professional Conduct:

- Rule 1.7(b) provides that a lawyer may not represent a client if the representation of that client may be materially limited by, among other things, “the lawyer’s own interests”;¹¹⁷ and
- Rule 2.1 requires that, in representing a client, a lawyer shall exercise “independent professional judgment and render candid advice.”¹¹⁸

It is always possible that an exchange of securities for fees reasonably may affect an attorney’s professional judgment on behalf of a client. In order to avoid impacting his or her professional judgment, the amount involved should be nominal from both the attorney’s perspective and the perspective of the client organization, and the attorney should place any

¹¹⁵ Quoting *Spilker v. Hankin*, 88 F.2d 35 (D.C. Cir. 1951) and citing *Stockton v. Ford*, 52 U.S. (11 How.) 232 (1850) and *Cupeiro v. Baron*, 555 So.2d 370 (Fla. Dist. Ct. App. 1989).

¹¹⁶ *The Law of Lawyering*, §12.4 at page 12-11. Section 126 of the *Restatement* addresses business transactions with clients in a manner that is consistent with the requirements of Colo. RPC 1.8(a).

¹¹⁷ Colo. RPC, Rule 1.7(b) (1997).

¹¹⁸ Colo. RPC, Rule 2.1 (1997).

stock certificates in the office safe and forget that they are there for as long as the representation is ongoing. This is difficult, to say the least.

Thus, while there is no prohibition against an attorney accepting stock for fees, or in making an investment in a client, the attorney would be well advised to include the disclosures required under Rule 1.8(a) in an appropriate engagement letter or other writing – as required by Rule 1.8(a)(3).

Rule 1.13 and Rule 1.6 – Representation of Organizations and Confidentiality

Colorado substantially revised its rules regarding confidentiality (Rule 1.6) and representation of entities (Rule 1.13) effective January 1, 2008. These rules are similar to the rules proposed by the Kutak Commission in 1982 which were rejected by the ABA's House of Delegates when considering revisions to the Model Rules of Professional Conduct. Similar proposals were rejected by the House in 1991 and again when proposed by ABA's Ethics 2000 Commission in August 2001.¹¹⁹ Thereafter significant events in the corporate governance landscape occurred. These events were named Enron, Worldcom, HealthSouth, Tyco CEO Dennis Kozlowski, and too many others. Senators and the public were shouting "where were the lawyers?"¹²⁰ As a result a committee of the ABA reconsidered the proposals received a year previously from the Ethics 2000 Commission, proposed them again to the ABA's House of Delegates, which adopted them in August 2002.

Rule 1.13 makes it clear that where the client is an entity, the attorney must always be aware that the entity is a collection of individuals. As stated in Rule 1.13 (both before and after amendment), where the entity is the client, the attorney for an entity "owes allegiance to the organization itself and not [to] its individual stockholders, directors, officers, employees, representatives or other persons connected with the entity." During the entity's operations over a period of time, the attorney will unquestionably develop close relationships with the individuals associated with the entity with whom the attorney is working. That relationship, no matter how friendly, cannot affect the attorney's representation of the entity or further corporate scandals are likely to occur.

As discussed above, one of the provisions of the Sarbanes-Oxley Act was § 307 which required the SEC to "issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing

¹¹⁹ See Stephen Gillers and Roy D. Simon, *Regulation of Lawyers: Statutes and Standards* 69-71 (2005 ed.) cited in *Report of the Task Force on the Lawyer's Role in Corporate Governance* at 77 (November 2006) by the Association of the Bar of the City of New York.

¹²⁰ See, e.g., Remarks of Senator John Edwards, 148 Cong. Rec. S6552 (daily ed. July 10, 2002) and Remarks of Senator Michael Enzi, 148 Cong. Rec. S6576 (daily ed. July 10, 2002). These remarks were made during the debate surrounding the adoption of the Sarbanes-Oxley Act of 2002, and specifically § 307 thereof. See text at notes 8-9, above.

and practicing before the Commission in any way in the representation of issuers.”¹²¹ The SEC adopted its attorney conduct rules effective in August 2003.¹²² Most financing and merger and acquisition transactions involve the offer, purchase, or sale of securities and, consequently, the SEC’s attorney conduct rules will likely apply. Even where the SEC’s attorney conduct rules do not apply, Rule 1.13 imposes obligations on attorneys representing entities.

Under Colorado Rule 1.13, where counsel to an entity knows that a person associated with that entity:

1. is engaged, intends to act or refuses to act in a manner;
2. related to the representation;
3. that is a violation of a legal obligation to the entity or a violation of law which might reasonably be imputed to the entity; and
4. is likely to result in substantial injury to the entity,

the attorney must proceed as reasonably necessary in the best interests of the entity, giving consideration to:

- a) the seriousness of the violation and its consequences;
- b) the scope and nature of the lawyer’s representation;
- c) the responsibility and the motivation of the person involved; and
- d) other relevant considerations.

Where the attorney has concerns in this regard, there are many actions the attorney can take to fulfill his or her legal duties. These include:

- Asking for reconsideration of the matter;
- Seeking a separate legal opinion;

¹²¹ 15 U.S.C. § 7245.

¹²² 17 C.F.R. § 205.1. Note that the term “appearing and practicing before the SEC” is interpreted very broadly and includes attorneys representing private issuers in transactions involving the issuance or transfer of securities. See Lidstone, *THE SECURITIES LAW DESKBOOK* (Bradford Publishing Co. 2007) at § 13.6 and § 13.7; Lidstone, “Sarbanes-Oxley Act of 2002: Impact on Private Companies and their Attorneys,” 33 *THE COLO. L. (CBA)*, no. 7 at 73 (July 2004).

- Referring the matter to a higher authority at the entity; or

Where the entity continues to act in the objectionable manner which the lawyer determines is a violation of law and is likely to result in substantial injury to the entity, the lawyer may resign.¹²³ Under 2008 changes, attorney's duty to report within the organization continues:

- If the lawyer reasonably believes that he was discharged by the client because of his compliance with Rule 1.13, or
- If the lawyer withdrew under circumstances that required the lawyer to report corporate wrongdoing.

Colorado Rule 1.13(c) permits the lawyer to reveal information related to the representation of the entity to third parties irrespective of whether such disclosure would violate Rule 1.6. Disclosure under Rule 1.13(c) is only permitted when, in the lawyer's judgment, disclosure is necessary to prevent substantial injury to the organization. Note that Rule 1.13 focuses the emphasis of the disclosure on injury to the organization.

Rule 1.6(b) permits (but does not require) disclosure by an attorney of the confidences of a client, when the attorney believes it necessary:

- To prevent reasonably certain death or substantial bodily harm;
- To prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another **and** in furtherance of which the client used or is using the lawyer's services; or
- To prevent, mitigate or rectify substantial injury to the financial interests or property of another" resulting from a crime or fraud "in furtherance of which the client has used the lawyer's services"

The focus of Rule 1.6(b) is not the attorney's client. The focus of Rule 1.6(b) is to protect third parties. Notably the rules do not require attorney disclosure in the circumstances outlined in the rule disclosure is instead permissible. Where the attorney becomes aware of one of the matters that may be subject to disclosure under Rule 1.6(b), the attorney's interests may diverge from the client as the attorney considers how to address the issues to his or her client and whether to make disclosure under Rule 1.6. One of the

¹²³ The duties of attorneys representing entities that file reports under the Securities Exchange Act of 1934 or which have filed registration statements under the Securities Act of 1933 have enhanced duties imposed by §307 of the Sarbanes-Oxley Act of 2002 and the rules the SEC has adopted thereunder. See Lidstone, *Am I My Brother's Keeper? Redefining the Attorney-Client Relationship*, 32 THE COLO. L. (CBA) No. 4, 11 (Apr. 2003).

concerns an attorney in such a position may have is potential aiding and abetting liability if the attorney is publicly silent in the face of such knowledge.¹²⁴ Even though the rules state that violation “should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached,”¹²⁵ it is likely that plaintiffs will argue that the rules reflect the standard of care in the community. Recently the Colorado Court of Appeals determined that attorneys could be held liable for aiding and abetting the breach of fiduciary duties. The Colorado Supreme Court overturned the appellate court’s decision on other grounds, but specifically left open the issue of whether an attorney can be held liable for an aiding and abetting the breach of fiduciary duties.¹²⁶ Regardless of civil liability, however, there is clear precedent that a lawyer may be disciplined for aiding and abetting a client’s financial crimes.¹²⁷

The 2008 amendments to Rules 1.13 and 1.6 make representation of organizations more difficult. When the impact of these new rules is fully understood, individuals associated with organizations may be less forthcoming with their legal counsel, concerned about the attorney’s duties to make disclosure, even when voluntary.

In 2003 the SEC proposed a requirement that attorneys, in circumstances similar to new Rule 1.6(b), make a ‘noisy withdrawal’ when the situation is such that the attorney can no longer represent the client.¹²⁸ As described above,¹²⁹ following the disclosure of the

¹²⁴ Consider the case where an attorney finds out about events in which a client participated which ultimately prove to have been fraudulent (although the attorney and the client may disagree with that characterization at the time). The attorney considers his or her Rule 1.6 obligations and determines not to make the permissive disclosure but simply resigns. Even though that failure to make permissive disclosure cannot be subject to a disciplinary proceeding, might it be sufficient for the attorney to be held responsible for aiding and abetting the client’s fraud?

¹²⁵ Colo. RPC Preamble and Scope, Comment [20].

¹²⁶ *Alexander v. Anstine*, 152 P.3d 497 (Colo. 2007).

¹²⁷ *In re DeRose*, 55 P.3d 126 (Colo. 2002) (Attorney was convicted of a felony charge of aiding and abetting when, on behalf of his clients, he engaged in eleven separate financial transactions structured to avoid federal financial reporting requirements. Through his criminal conduct, the attorney violated C.R.C.P. 251.1(b) and Rule 8.4(b), and was therefore disbarred.)

¹²⁸ The Commission proposed rules under § 307 of the Sarbanes-Oxley Act of 2002 on November 6, 2002. SEC Rel. 33-8150, 34-46868, IC-25829, and adopted final rules on January 29, 2003 (effective August 5, 2003). SEC Rel. 33-8185, 34-47276, IC-25929. Although the rules as proposed included the provision for a “noisy withdrawal,” the Commission deferred consideration of those rules. SEC Rel. 33-8186, 34-47282, IC-25920. In that release, the Commission itself acknowledges that the “noisy withdrawal” proposal went beyond the requirements of Sarbanes-Oxley. Both Senators Edwards and Enzi made it clear in their remarks that § 307 “would not require the attorneys to report violations to the [Commission], only to corporate legal counsel or the CEO, and ultimately to the board of directors.” 148 Cong. Rec. S6555 (Daily ed., July 10, 2002). Nevertheless, the proposed rules have not been withdrawn. See Lidstone, “*Am I My Brother’s Keeper? Redefining the Attorney-Client Relationship*,” 32 THE COLO. L. (CBA), no. 4 at 11 (April 2003).

¹²⁹ See text at notes 23-26.

Ponzi scheme operated by Allen Stanford, his former attorneys effected a noisy withdrawal, advising the SEC in writing that:

“I disaffirm all prior oral and written representations made by me and my associates to the SEC staff regarding Stanford Financial Group and its affiliates.”

The Department of Justice revised its guidelines for deciding when to seek an indictment of a corporation following the corporate scandals of the early 2000’s, culminating in the McNulty Memorandum,¹³⁰ which became effective in 2006. The McNulty Memorandum provided that waivers of attorney-client privilege would be viewed favorably by prosecutors, and a failure to waive corporate attorney-client privilege would be viewed negatively in making decisions whether to charge a corporation or in determining the terms of a settlement.

In 2008 (before the economic crisis that hit in September 2008), the pendulum swung back toward the protection of attorney-client privilege for corporations. After significant Congressional pressure, the Justice Department determined it may have gone too far in essentially forcing corporations to waive attorney-client privilege or work-product as a condition to cooperation credit. In a speech by Deputy Attorney General Mark R. Filip,¹³¹ the Department announced significant changes in its policies defining cooperation in the Department’s corporate charging policy:

- Credit for cooperation will not depend on whether a corporation has waived attorney-client privilege or work product. Prosecutors will provide credit based on the corporation’s disclosure of relevant facts.
- Prosecutors are forbidden from asking for non-factual attorney-client privileged communications and work-product, such as legal advice.
- In assessing credit for cooperation, prosecutors may not consider whether the corporation advanced or paid attorneys’ fees for employees, officers, or directors unless the payment “would rise to the level of criminal obstruction of justice” which would not generally be the case.
- In assessing credit for cooperation, prosecutors may not consider whether the corporation disciplined or terminated employees considered to be at fault for the alleged violations.

¹³⁰ Memorandum dated December 12, 2006, from Paul J. McNulty, Deputy Attorney General, U.S. Department of Justice, available at www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.

¹³¹ Aug. 28, 2008, avail. at www.usdoj.gov/dag/speeches/2008/dag-speech-0808284.html.

Deputy Attorney General Filip added that, “[n]o corporation is obligated to cooperate or to seek cooperation credit by disclosing information to the government. Refusal by a corporation to cooperate, just like refusal by an individual to cooperate, is not evidence of guilt... It simply means that the corporation will not be entitled to mitigating credit for cooperation....” These principles are now included in the United States Attorneys’ Manual at Chapter 9-28.000. In step with the Justice Department, the SEC revised its Enforcement Manual in October 2008. The new SEC guidance directs staff to consider that “[a] party’s decision to assert a legitimate privilege will not negatively affect their claim to credit for cooperation.”¹³² These moves by federal enforcement agencies may eventually lead to further changes in the Rules of Professional Conduct to strengthen the attorney-client privilege which was weakened by the 2008 version of the Rules.

Rule 1.8 – Conflicts of Interest: Current Clients

Rule 1.8 sets forth specific prohibitions for situations that can commonly arise during the attorney-client relationship. Of most interest to transactional attorneys is Rule 1.8(a) regarding entering into a business transaction with a client. To comply with Rule 1.8(a), the transaction by which the lawyer acquires the interest and its terms must be:

- fair and reasonable to the client; and
- fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client.

Rule 1.8(a) also requires the lawyer advise the client that he or she should seek independent counsel to review the transaction and give the client reasonable time to do so. Finally, Rule 1.8(a) requires the lawyer to obtain, in a writing signed by the client, informed consent to the essential terms of the agreement.¹³³

The Rule 1.8(a) requirements apply not only to direct attorney-client transactions, but also indirect transactions in which the attorney may have an interest. For example, in 2009, the Presiding Disciplinary Judge publicly censured an attorney who failed to withdraw from representing a client when he learned that his wife was in a business transaction with the client.¹³⁴ The PDJ attributed her actions to the attorney. In issuing the censure, the PDJ also found that the attorney failed to make appropriate disclosures to the client and failed to ensure that his wife’s conduct was compatible with his ethical obligations.

¹³² SEC Enforcement Manual, §4.3, revised October 6, 2008.

¹³³ In *People v. Sanford*, 2009 WL 1397226 (Colo. OPDJ, Apr. 22, 2009), the attorney was suspended from the practice of law for 60 days for entering into “numerous business transactions with his client” and failing to comply with the obligations of Rule 1.8(a).

¹³⁴ *People v. Montoya*, 2009 WL 1037714 (Colo. OPDJ Apr. 17, 2009).

Rule 2.3 – Evaluation for Use by Third Parties (e.g., Legal Opinions)¹³⁵

Colorado Rule 2.3 has generally been interpreted to allow attorneys for clients to issue legal opinions to third parties in connection with the closing of a transaction or in other circumstances. A legal opinion places the lawyer in the odd position of issuing legal advice to a person not his or her client and generally disclosing confidences about the client. The principal change between the current Colorado rule and the new rule is that, under new Rule 2.3(b), the client’s “informed consent” is required only when the lawyer knows or reasonably should know that the evaluation is likely to affect the client’s interests materially and adversely. As described in Paragraph [5] of the Comment to this rule:

When a client requests a lawyer to provide an opinion for the benefit of third parties and the opinion is consistent with the client’s interests, there is no good reason to require the client’s consent.

Rendering a legal opinion to third parties also invokes other Rules of Professional Conduct:

- The lawyer must be competent to render the opinion (Rule 1.1), which includes an understanding of customary practice as defined by the literature and elsewhere;¹³⁶
- The lawyer must preserve the confidentiality of client information (Rule 1.6);
- The lawyer’s conduct must conform to the requirements of the law and must be characterized by independent judgment and truthfulness (Rules 1.2, 2.1 and 4.1); and
- The lawyer must avoid conflicts of interest (Rules 1.7 and 1.9).

¹³⁵ For a discussion of Colorado legal opinion practice within the national scope, see Lidstone and Belak, *Danger Ahead! Legal Opinions for Colorado Lawyers*, 38 THE COLO. L. (CBA) No. 4 at 25 (Apr. 2009).

¹³⁶ This literature is easily available and much of it can be found in the ABA’s legal opinion resource center. <http://www.abanet.org/buslaw/tribar/home.shtml>. The website of the American College of Real Estate Lawyers (www.acrel.org) includes valuable information for persons writing legal opinions in real estate transactions. Of these, the ABA’s “Guidelines for the Preparation of Legal Opinions,” 57 The Bus. L. (ABA) 875 (2002) and “Legal Opinion Principles,” 53 The Bus. L. (ABA) 831 (1998), are among the most significant, as are the reports prepared by the TriBar Opinion Committee. There are also numerous treatises available, including contributions from a number of Colorado lawyers in Holderness and Wunnicke, *Legal Opinion Letters Form Book* (Aspen Law Business, 2nd Ed. 2003). Chapter 1B of the 2008 Supplement is a primer for lawyers not experienced in opinion practice. *Glazer and Fitzgibbon on Legal Opinions: Drafting, Interpreting, and Supporting Closing Opinions in business Transactions* (Aspen Law & Business, 3rd Ed.) is another valuable resource for legal opinion preparers.

Formal Opinion 113 – Ethical Duties to Disclose Errors to the Client

Ethics Opinion 113 issued on November 19, 2005 by the Ethics Committee of the Colorado Bar Association reminds lawyers that it is their duty under Rule 1.4 to inform clients about material developments in the subject matter of the representation.¹³⁷ Opinion 113 states that this includes “material adverse developments . . . resulting from the lawyer’s own errors.” The lawyer is not obligated to disclose all errors – only errors that clearly prejudice a client’s claim or rights must be disclosed under Opinion 113. Where the lawyer is in doubt about the obligation to disclose, it would be prudent for the lawyer to seek outside counsel. Consulting with lawyers in the same firm may not be appropriate because they each have the same problem vicariously.

Where the lawyer can fix the error without (or prior to) disclosure, then the Opinion provides that disclosure is not necessary. The cure, however, cannot lead to any further prejudice to the client.

After the lawyer has disclosed the error, the lawyer “may continue to represent the client in . . . compliance with Colo. RPC 1.7(b).” The opinion goes on to acknowledge that “in many if not most circumstances, the interest of the attorney in avoiding liability will be consistent with the interest of the client in a successful representation.” There are potentially cases where the lawyer’s interest in avoiding liability might influence his or her willingness to pursue a strategy that would avoid the attorney’s liability at the expense of the success of the representation – in that case, continued representation by the lawyer would be improper under Rule 1.7(b).

Ethics opinion 113 goes on to state that, when admitting an error to a client, the attorney should also give consideration to notifying the attorney’s malpractice insurance carrier. Finally, the opinion notes that it does not consider whether an attorney’s failure to notify a client of an error gives rise to a cause of action against the lawyer, separate and apart from any cause of action arising from the error itself. Paragraph [20] of the scope of the Rules of Professional Conduct does state:

“Violation of a Rule should not give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached.”

In attempting to rectify the results of the error, an attorney may not obtain a release of liability from the client except in compliance with Rule 1.8(h).

¹³⁷ See Houghtaling, *Disclosing Mistakes in Light of Ethics Opinion 113*, 35 THE COLO. L. No. 4 at 89 (Apr. 2006) for a good discussion of Opinion 113.