

## IN-HOUSE COUNSEL DRAFT OPINION

## ISSUES:

(1) What are the conflict of interest duties of an in-house lawyer when moving from one company to another?

(2) What conflicts of interest are presented by a stock option agreement between in-house lawyer and the company?

(3) What conflicts on interests arise from in-house lawyer's representation of company shareholders in connection with proposed acquisition by a third party via a stock purchase transaction where lawyer is a shareholder of company?

DIGEST: [INSERT]

## AUTHORITIES

INTERPRETED: Rules of Professional Conduct 1.0.1, 1.7, 1.8.1, 1.9, 1.10, 1.13

## STATEMENT OF FACTS AND QUESTIONS PRESENTED

After practicing law for 5 years as in-house legal counsel for a software company ("Old Company"), Lawyer has decided to take a position as General Counsel for a closely-held software company ("Company"), owned by three shareholders ("Shareholders"). The Shareholders make up the Board of Directors ("Board"). Lawyer is expected to head a small team of three lawyers ("Legal Department").

Company is a competitor of Old Company in that both are in the process of registering competing patents for similar technology. Lawyer was not part of the team that advised Old Company concerning its technology and patent applications. However, Lawyer was responsible for advising Old Company on legal issues concerning its business strategies and marketing, which necessarily involved patented products.

**Question 1:** *Before formally accepting the position, Lawyer wants to know how to analyze and navigate any potential conflicts that Lawyer might have based on Lawyer's work at Old Company and to what extent an ethical screen may be required.*

As part of Lawyer's employment agreement with the Company, Lawyer is presented with a stock option agreement that is offered to the Company's key employees. The agreement states that Lawyer has an option to purchase a certain number of shares of the Company's common stock at an exercise price equal to the fair market value of such shares on the date of the grant, based on the Company's Stock Incentive Plan. The agreement also states that the securities will vest over time, at increasing percentages over the course of five years. The agreement also states that in the event of a merger with or acquisition by another company, the vesting of the Lawyer's option will immediately accelerate so as to become fully vested.

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**Question 2:** *Lawyer wants to know whether the stock option agreement presents any conflicts of interest, and if so, how and when such conflicts of interest should be addressed with the Company.*

Lawyer begins working for Company. Three years later, after Lawyer's securities are 30% vested, Company begins talks with another Company (Public Company) under which Public Company offers to acquire Company through a stock purchase and Company would become a wholly-owned subsidiary of Public Company. Company's CEO asks Lawyer to advise the Shareholders (i.e., the sellers under the proposed deal) about the benefits and risks of the proposed deal, and potential negotiation terms including a sales price.

**Question 3:** *Lawyer wants to know whether her status as a stockholder in the Company presents a conflict of interest in connection with the requested advice, and if so, whether the conflict may be waived by the Company. Lawyer also wants to know whether the requested advice to the Shareholders will present conflicts of interest between and among the Shareholders and/or between the Shareholders and the Company. Lawyer also wants to know whether she may ethically represent Company in direct negotiations with Public Company and/or its counsel.*

## DISCUSSION

Generally, the California Rules of Professional Conduct (CRPC) apply equally to in-house lawyers who are licensed or registered<sup>1</sup> in California to practice law and all other California lawyers. In-house lawyers have attorney-client relationships with the organizations that employ them. *Gutierrez v. G & M Oil Co., Inc.* (2010) 184 Cal.App.4<sup>th</sup> 551, 559. An organization's legal department is encompassed within the definition of "law firm" under the rules. Rule 1.0.1(c) ("Firm" or "law firm" means = . . . lawyers employed in a legal services organization or in the legal department, division or office of a corporation, of a government organization, or of another organization.") A lawyer's duties to an organizational client are the same whether they are "employed or retained" by the organization. Rule 1.13(a). The underlying purposes of a lawyer's fiduciary duties – protecting the public and the integrity of the legal system and promoting the administration of justice and confidence in the legal profession – are not diminished simply because the lawyer is employed rather than retained by an organizational client.

However, the nature of an in-house lawyer's fiduciary duties may be relative to the nature of the attorney-client relationship between employer and employee. "For example, in-house lawyers may be seen to owe different duties than independent lawyers, perhaps because they are viewed as employees of the client directly rather than indirectly." Klein, No Fool for a Client: The Finance and Incentives Behind Stock-Based Compensation for Corporate Attorneys, 1999 Colum. Bus. L. Rev. 330. Accordingly, "[t]he dual status of in-house counsel—acting as both employee and attorney—and the dual status of the company—acting as both employer and client—can pose some challenging questions about when one role takes precedence over another." *Missakian v. Amusement Industry, Inc.* (2021) 69 Cal. App. 5th 630, 652; *see also, General Dynamics Corp. v. Superior Court (Rose)* (1994) 7 Cal.4<sup>th</sup> 1164 (recognizing this dynamic in the employment law context).

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<sup>1</sup> See, California Rules of Court (CRC) 9.46 (Registered In-House Counsel).

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Potential conflicts of interest arising from an in-house lawyer's movement from one in-house position to another and an in-house lawyer's ownership of stock or stock options in their employer present such challenging questions. As explained below, although the CRPC apply with equal force to in-house lawyers as they do to independent lawyers, the application of the relevant rules, must be analyzed in the context of both the attorney-client and employer-employee relationships at issue.

## APPLICATION

### I. What is the Scope of Lawyer's Duties To Their Former Employer, Old Company?

The California Rules of Professional Conduct (and Model Rules of Professional Conduct) are typically directed at lawyers practicing at law firms, so in-house lawyers must consider the purpose of each rule as it applies to their practice. As discussed above, an in-house lawyer (a lawyer "employed or retained by an organization") represents the organization itself as a client. (CRPC 1.13(a).) Thus, Lawyer's previous client was Old Company, and Lawyer's current client is Company, acting through its authorized constituents. Keeping in mind who is the client—whether former or current—is important in analyzing potential conflicts, confidential information, and other duties. yer.

A lawyer owes two duties to a former client: a duty of loyalty (to refrain from doing "anything that will injuriously affect the former client in any matter<sup>2</sup> in which the lawyer represented the former client"), and a duty of confidentiality (to refrain from ever using against the former client "knowledge or information acquired by virtue of the previous relationship.") (Comment [1] to Rule 1.9 [citing *Oasis West Realty, LLC v. Goldman* (2011) 51 Cal.4th 811, and *Wutchumna Water Co. v. Bailey* (1932) 216 Cal. 564].)

Alawyer must obtain informed written consent from a former client before representing another client "in the same or a substantially related matter" in which the current client's interests are "materially adverse" to the former client's interests (Rule 1.9(a)). Two matters are "the same or substantially related" if they involve a substantial risk of a violation of the duty of loyalty or the duty of confidentiality (or both). CRPC 1.9, Comment [3]. "For example, this will occur: (i) if the matters involve the same transaction or legal dispute or other work performed by the lawyer for the former client; or (ii) if the lawyer normally would have obtained information in the prior representation that is protected by Business and Professions Code section 6068, subdivision (e) and rule 1.6, and the lawyer would be expected to use or disclose that information in the subsequent representation because it is material to the subsequent representation." *Ibid*.

Thus, rule 1.9(a) "prohibits a lawyer from representing a person whose interests are materially adverse to those of his former employer if he personally represented the former employer in the same or substantially related matter." ABA Form. Opn. 99-415. Furthermore, even if the lawyer did not personally represent the former employer in the same or a substantially related matter, "if others in the legal department did, and the former in-house lawyer acquired protected information during his

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<sup>2</sup> [DEFINITION OF MATTER] CRPC 1.7(e) For purposes of this rule, "matter" includes any judicial or other proceeding, application, request for a ruling or other determination, contract, transaction, claim, controversy, investigation, charge, accusation, arrest, or other deliberation, decision, or action that is focused on the interests of specific persons, or a discrete and identifiable class of persons.

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employment that is material to the prospective client’s matter,” the same prohibitions under rule 1.9(a) apply. CRPC 1.9(b); ABA Form. Opn. 99-415. Finally, as with any former client, an in-house lawyer is prohibited from using or disclosing their “former employer’s protected information (unless it is generally known) . . . even if the lawyer is not adverse to the former client or the adversity is in a matter that is not substantially related to the prior representation.” *Ibid*.

For an in-house lawyer who provided legal advice to a company concerning a broad range of matters, the question of whether representation of a new company is considered “the same or [] substantially related” is a more difficult question than a lawyer performing legal work at a law firm on a case, matter, or transaction basis. The Second Circuit test of “substantially related” matters—requiring demonstration of either (1) a “patently clear” relationship between the issues in the prior and present representations, or (2) that the issues are “identical” or “essentially the same”—offers little guidance here. (*Gov’t of India v. Cook Inds., Inc.* (2nd Cir. 1978) 569 F.2d 737, 739-40.) [REPLACE WITH CA LAW AND EXPAND ANALYSIS]

Here, Lawyer was not part of the team that advised Old Company concerning its technology and patent applications. Instead, Lawyer advised Old Company generally on legal issues, including its business strategies and marketing, and will certainly advise Company on similar matters as head of a small legal team. Lawyer’s legal advice to Old Company on its business strategies and marketing necessarily involved patented products.

General legal advice is too broad to be considered a “matter”—to do so would necessitate the conclusion that every matter undertaken by an in-house lawyer is substantially similar to every other one, and the result would be a duty of extra loyalty to the detriment of a lawyer’s career mobility. Lawyers’ mobility—and ability to leverage the expertise and knowledge gained along their career path—is increasingly important. (See ABA Form. Opn. 99-415 at 2 [“The increased frequency with which lawyers employed by an organization are hired by a competitor or by a law firm seeking the expertise gained by the lawyer in his former position has resulted in a greater focus on [the issue of in-house lawyers’ duties to former clients].”].)

On the other hand, the general nature of an in-house lawyer’s work does not create a shield such that an in-house lawyer will have no conflicts and owes no duty to former lawyers. Instead, Lawyer must evaluate the extent and nature of confidential information learned in Lawyer’s former employment that would be material to the new matter. (See 1.9, Comment [3], noting that a lawyer with confidential information would be expected to use or disclose that information in a substantially similar matter.) Although Lawyer’s prior general legal advice involved Old Company’s patented products, the facts do not suggest that the advice included patent applications or implicated specialized patent law issues that are substantially related to Company’s pending patent registration. The general legal advice alone, would not be considered a substantially related matter just because it involved Old Company’s patented products, unless Lawyer acquired confidential information from the prior advice that would be material to the Company’s patent registration.

Even if a matter is not substantially related and a lawyer does not have confidential information within the meaning of Business and Professions Code section 6068, subdivision (e) and rules 1.6 and 1.9(c), a

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lawyer may have gained extensive knowledge of a company's strategies, policies and tendencies (or specific facts, like its financial situation).

However, similar to the analysis above regarding the substantial relationship, knowledge of a company's "playbook" alone is not enough to disqualify a lawyer based on the duty of loyalty; instead, there must be a showing that the information gained from the "playbook" is of "critical importance" to the matter at hand. (See *Fremont Indem. Co. v. Fremont Gen. Corp.* (2006) 143 Cal.App.4th 50, 65.) Here, no facts suggest that Lawyer gleaned information from Old Company's "playbook" regarding its technology or patent applications that would rise to the level of material importance; thus, absent additional facts about confidential information, the competing nature of the two companies and the similarity of Lawyer's roles at the two companies does not mean that Lawyer has violated the duties of loyalty or confidentiality to Old Company by accepting employment at Company.<sup>3</sup>

*DR: capture no conflict/duty to screen, in house counsel discussing with outside counsel* *KR: More case law about not substantially related* *BK: Screens might not be possible under certain circumstances*

## II. What are Lawyer's Ethical Duties Regarding Stock Options Offered by New Company as Compensation for Employment?

### A. Potential Application of CRPC 1.8.1

In the traditional attorney-client relationship, a lawyer's acceptance of stock or stock options from a client in lieu of fees for legal services is subject to rule 1.8.1, which governs when a lawyer knowingly acquires an ownership or other pecuniary interest adverse to a client. See Rule 1.8.1, Comment [5] ("This rule does not apply to the agreement by which the lawyer is retained by the client, unless the agreement confers on the lawyer an ownership, possessory, security, or other pecuniary interest adverse to the client."); ABA Formal Opn. 00-418 ("[A] lawyer who acquires stock in her client corporation in lieu of or in addition to a cash fee for her services enters into a business transaction with a client, such that the requirements of Model Rule 1.8(a) must be satisfied."). If rule 1.8.1 applies, the lawyer must ensure that the following requirements are met:

(a) the transaction or acquisition and its terms are fair and reasonable to the client and the terms and the lawyer's role in the transaction or acquisition are fully disclosed and transmitted in writing to the client in a manner that should reasonably have been understood by the client;

(b) the client either is represented in the transaction or acquisition by an independent lawyer of the client's choice or the client is advised in writing\* to seek the advice of an independent lawyer of the client's choice and is given a reasonable opportunity to seek that advice; and

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<sup>3</sup> Insert brief discussion re possible screening under CRPC 1.10? *DR: capture no conflict/duty to screen, in house counsel discussing with outside counsel* *KR: More case law about not substantially related* *BK: Screens might not be possible under certain circumstances*

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(c) the client thereafter provides informed written consent to the terms of the transaction or acquisition, and to the lawyer's role in it.

The purpose of the rule is to address the inherently imbalanced relationship between attorney and client.

*Beery v. State Bar* (1987) 43 Cal.3d 802, 812-813, quoting, *Felton v. Le Breton* (1891) 92 Cal. 457, 469 [28 P. 490], and citing, *Estate of Witt* (1926) 198 Cal. 407, 419; *Gold v. Greenwald* (1966) 247 Cal. App. 2d 296, 305-306. "The law accordingly takes a jaundiced view of business transactions between attorneys and their clients." *Ferguson v. Yaspan* (2014) 233 Cal.App.4th 676, 685. Indeed, "the law presumes" attorneys engaging in such transactions "wear" a "black" hat. *Mayhew v. Benninghoff* (1997) 53 Cal.App.4th 1365, 1369.<sup>4</sup>

However, these concerns are typically absent in the in-house context, where the new lawyer is offered the same general compensation terms, including stock and stock options, as those offered to other key employees. Indeed, the power dynamic may be reversed. [F]rom an economic standpoint, the dependence of in-house counsel is indistinguishable from that of other corporate managers or senior executives who also owe their livelihoods and career goals and satisfaction to a single organizational employer." *General Dynamics Corp. v. Superior Court*, *supra* 7 Cal. 4th at 1172. In addition, the in-house lawyer's employment agreement may be prepared and/or presented by the General Counsel, employment counsel, or other company counsel.

In *Chism v. Tri-State Construction Inc.* (2016) 193 Wn.App. 818, a Washington state court of appeals addressed application of Washington State's version of rule 1.8.1, in the in-house context.<sup>5</sup> There, Mr. Chism, Tri-State Construction Inc.'s (Tri-State) general counsel, sued Tri-State for breach of compensation contracts to recover allegedly unpaid bonuses, which were drafted by Mr. Chism and negotiated during his tenure as general counsel. The court of appeals reversed the trial court's decision finding that the agreements to pay bonuses to Mr. Chism constituted modifications of his original employment agreement and thus were subject to RPC 1.8(a). 193 Wn.App. 818, 852. In so holding, the

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<sup>4</sup> A lawyer's failure to satisfy the requirements of rule 1.8.1 subjects a lawyer to discipline. However, a violation of the rule does not by itself provide a basis for civil liability. Rather, the rule's "statutory counterpart—Probate Code section 16004—erects a presumption that transactions between an attorney and client 'by which the [attorney] obtains an advantage' are a breach of the attorney's fiduciary duty and are the product of undue influence." *Ferguson v. Yaspan*, *supra*, at 684-685; *see also*, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135, 1140. "The presumption is rebuttable, and the attorney's inability to do so renders the transaction voidable at the client's option." *Ferguson v. Yaspan*, *supra* at 685.

<sup>5</sup> Washington State Bar Rule of Professional Conduct [RPC] 1.8 provides, in pertinent part:

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of an independent lawyer on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

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court of appeal reasoned that [SB adding footnote making distinctions b/w circumstances; offer vs. attorney-client relationship]

The trial court's conclusions regarding these agreements gloss over the essential differences between fee agreements and wage contracts. Under the trial court's interpretation of the rule, every compensation agreement entered into between a lawyer-employee and a current client-employer would be subject to RPC 1.8(a). This would include, for example, every agreement increasing a lawyer-employee's wages or benefits. . . . By rendering [the] compensation agreements prima facie fraudulent, the trial court's interpretation would disturb the settled expectations of many lawyer-employees. It would also subject standard wage contracts for lawyer-employees, which frequently include nonmonetary compensation, to greater scrutiny overall than standard fee contracts, which are generally exempt from the rule. Moreover, it would do this without addressing whether lawyer wage contracts should be exempt from the rule as another type of "transaction [in which] the lawyer has no advantage in dealing with the client," RPC 1.8 cmt. 1, given that, in general, employees are thought to have relatively little power compared with that of their employers. Cf. *Rickman v. Premera Blue Cross*, 184 Wn.2d 300, 309, 358 P.3d 1153 (2015) (stating, regarding the wrongful termination cause of action, "allowing an exception to the at-will doctrine serves to equalize the imbalance of power that exists in an employment relationship").

*Chism v. Tri-State Construction Inc.*, *supra*, 193 Wn.App. 818, 853. See also, Washington State Bar Association Advisory Opinion:

A lawyer negotiated with corporate management over an employment contract to serve as legal counsel. The contract provided that part of the lawyer's compensation would be shares in the publicly traded corporation. The Committee was of the opinion that negotiations as described by you in working out an employment contract for the full time job of legal counsel for a corporation does not violate RPC 1.8. It appeared to be an arm's length transaction, and it did not appear that you were in any way giving legal advice to the corporation.

In other words, the Washington State Bar and court of appeals take the position that when placed in the employment context, the in-house lawyer's initial employment agreement containing stock grants or options, as well as subsequent adjustments to the lawyer's salary or "wages," are substantively similar to a typical attorney fee agreement, which is presumed to be an arms-length transaction. .<sup>6</sup>

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<sup>6</sup> See, rule 1.8.1, Comment [5]: "This rule does not apply to the agreement by which the lawyer is retained by the client, unless the agreement confers on the lawyer an ownership, possessory, security, or other pecuniary interest adverse to the client." See also, rule 1.8.1, Comment [6] "This rule does not apply . . . to standard commercial transactions for products or services that a lawyer acquires from a client on the same terms that the client

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The ABA Task Force on the Independent Lawyer ["Task Force"] in its report, *Lawyers Doing Business with Their Clients: Identifying and Avoiding Legal and Ethical Dangers* 56 (2001) [hereafter "Independent Lawyer Report"] reached a similar conclusion: "In the usual case, the receipt of equity-based compensation by in-house counsel would not appear to be the type of "business transaction with a client" contemplated by Rule 1.8. Option or restricted stock grants (the usual forms of equity compensation paid to in-house attorneys) are merely a form of compensation and, like cash, are a facet of the general employment relationship rather than part of or related to any particular transaction or undertaking." The Task Force noted that the "timing, size and conditions" placed on stock grants are typically the result of unilateral decisions by the corporate employer, in consultation with outside advisors and counsel. In short, the Task Force concluded, such stock grants, under normal circumstances, should not create interests that are "adverse" to the company's interests.

However, a distinction must be made between an employment agreement offered by an established company that contains stock grants or options as a general form of employment compensation to the potential in-house attorney, and other transactions with a potential or existing client in which the attorney, who serves as in-house counsel or corporate counsel for the client, is afforded stock grants or options. For example, Rule 1.8.1 applies to situations where the attorney and an existing or new client form a business together as owners or shareholders, and the attorney provides legal services to the newly-formed business entity.<sup>7</sup> See, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135.

Likewise, an in-house attorney for an existing entity is required to comply with Rule 1.8.1 where stock ownership is offered or increased as part of a specific transaction or undertaking rather than as part of the initial employment agreement or periodic performance reviews. *Passante v. McWilliam* (1997) 53 Cal. App. 4th 1240 is instructive. There, the company was in need of capital and the company's corporate lawyer had arranged additional funding. The "grateful board" promised three percent of company stock to the lawyer. The lawyer sued the company after its board reneged on the promise. The court held that the lawyer was required to comply with former rule 3-300 given the lawyer's fiduciary relationship with the company as its corporate lawyer who should have given "all that reasonable advice against himself that he would have given him against a third person." *Passante v. McWilliams, supra*, 53 Cal.App.4th 1240, 1248 (internal quotations and citations omitted). Had he done so, "[i]ndependent counsel would likely have at least reminded the board members of the obvious—that a grant of stock to Passante might complicate future capital acquisition." *Ibid*.

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generally markets them to others, where the lawyer has no advantage in dealing with the client." Wa. RPC 1.8(a), Comment [1] is similar: "[RPC 1.8(a)] does not apply to ordinary fee arrangements between client and lawyer, which are governed by Rule 1.5, although its requirements must be met when the lawyer accepts an interest in the client's business or other nonmonetary property as payment of all or part of a fee. In addition, the Rule does not apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable."

<sup>7</sup> It is irrelevant that the lawyer is not formally designated as "general counsel" or "in-house counsel" for the business entity, or whether the lawyer provides both legal and nonlegal services. "When a member performs both legal and non-legal professional services for a client, the member is subject to the California Rules of Professional Conduct with respect to all of those services." Cal. Form. Opn. 1999-154.



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Here, Lawyer is presented with a stock option agreement that is offered to the Company's key employees as part of the Company's Stock Incentive Plan. The securities vest incrementally over time. Thus, stock options are offered as a standard form of compensation in the proposed employment agreement and not in connection with a particular transaction or undertaking. It is an arms-length transaction that does not trigger the requirements under rule 1.8.1.

[SUMMARY]

] JF: Refine, reach out to other jurisdictions/ABA to support argument, CC: 1.5 applies to compensation agreements? Address where 1.5 goes/footnote

### B. Potential Application of CRPC 1.7

Lawyer must separately consider whether the stock option provisions in the employment agreement present a "material limitation" conflict of interest under rule 1.7(b). Specifically, rule 1.7(b) prohibits representation of a client if the representation "may be materially limited . . . by the lawyer's own interests," without the informed written consent of the client. Further, the lawyer cannot represent the client even with the requisite consent from the client if the lawyer does not "reasonably believe[] that the lawyer will be able to provide competent and diligent representation to each affected client." Rule 1.7(d)(1). Thus, where the lawyer has a personal interest in the subject matter of the representation, the lawyer must assess whether their independent judgment will be materially impacted to the detriment of the client. See, e.g., Model Rule 1.7, Comment [10]: "For example, if the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. . . . See Rule 1.8 for specific Rules pertaining to a number of personal interest conflicts, including business transactions with clients."

In ABA Formal Opn. 00-418, the Committee opined that although issuance of stock to outside counsel in lieu of fees mandated compliance with Model Rule 1.8(a) (the equivalent to CRPC 1.8.1), it "creates no inherent conflict of interest" under the "material limitation" conflict provisions of Model Rule 1.7(b). The Committee explained: "Indeed, management's role primarily is to enhance the business's value for the stockholders. Thus, the lawyer's legal services in assisting management usually will be consistent with the lawyer's stock ownership. In some circumstances, such as the merger of one corporation in which the lawyer owns stock into a larger entity, the lawyer's economic incentive to complete the transaction may even be enhanced." Nevertheless, the Committee also cautioned that particular circumstances may dictate compliance with Model Rule 1.7(b):

For example, the lawyer might have a duty when rendering an opinion on behalf of the corporation in a venture capital transaction to call upon corporate management to reveal material adverse financial information that is being withheld, even though the revelation might cause the venture capital investor to withdraw. In that circumstance, the lawyer must evaluate her ability to maintain the requisite professional independence as a lawyer in the corporate client's best interest by subordinating any economic incentive arising from her stock ownership. The lawyer also must consider whether her stock ownership might create questions concerning the objectivity of her opinion. She must

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consult with her client and obtain consent if the representation may be materially limited by her stock ownership.

The conflict could be more severe. For example, the stock of the client might be the lawyer's major asset so that the failure of the venture capital opportunity could create a serious financial loss to her. The lawyer's self-interest in such a case probably justifies a reasonable belief that her representation of the corporation would be affected adversely. This would disqualify her under Rule 1.7(b) from providing the opinion even were the client to consent.

However, this does not render rule 1.7(b) wholly inapplicable to an in-house lawyer who owns stock or stock options. *See also*, Independent Lawyer Report, p. 56 ("To the extent . . . that the receipt of such compensation or the ownership of equity in the employer company might raise a question as to a potential conflict of interest or impairment of the representation, Rule 1.7 would govern.")

Company's offer of stock options as part of its Stock Incentive Plan itself may not present a significant risk that Lawyer's independent judgment will be materially limited to the detriment of the Company. "Given the relatively limited equity stake of corporate counsel in most cases, the lawyer's ownership interest usually would not materially limit the representation. Indeed, equity-based compensation grants generally are made in small increments over time and, at the time made, are restricted in ways that give them only contingent, future value." Independent Lawyer Report, p. 56. In other words, it is not reasonably foreseeable at this early juncture in the employment relationship how Lawyer's future investments may impact their professional judgment in performing a wide variety of legal services on a day-to-day basis. There are no "relevant circumstances" and "material risks, including any actual or reasonably foreseeable adverse consequences of the proposed course of conduct" that Lawyer could explain for which informed consent from Company would be required. CRPC 1.01(e) [definition of "informed consent"].

The stock option agreement also provides that in the event of a merger with or acquisition by another company, the vesting of the Lawyer's stock options will immediately accelerate so as to become fully vested. The provision presents a hypothetical upon which Lawyer could possibly envision various scenarios in which Lawyer's professional judgment could be materially and adversely impacted. However, a "mere hypothetical conflict is insufficient;" rather, there must be a "reasonable likelihood an actual conflict will arise." *Havasu Lakeshore Investments LLC. v. Fleming* (2013) 217 Cal.App.4<sup>th</sup> 770, 779 [DOUBLECHECK THIS]. See also, ABA Model Rule 1.7, comment [8]: "The mere possibility of subsequent harm does not itself require disclosure and consent." Here, without more foundational facts such as whether Company intends to entertain a merger or acquisition deal, the imminency and potential terms of the deal, and the percentage of Lawyer's assets representing Company stock once fully vested, among other unknown factors, a "material limitation" conflict is not *reasonably* foreseeable.

Accordingly, the proposed employment agreement containing the stock option provisions do not present a rule 1.7(b) "material limitation" conflict of interest requiring informed written consent from Company before Lawyer takes the job.

**III. Question 3: What are Lawyer’s Ethical Duties to Company and the Individual Shareholders Concerning the Sale?**

Three years into Lawyer’s role as in-house counsel, when Lawyer’s stock options are 30% vested, acquisition of Company by Public Company is a foreseeable reality and no longer a hypothetical. Thus, at this juncture, Lawyer is required to assess whether their ownership interests present a significant risk that their independent judgment in providing advice to Company about the sale will be materially limited. “[B]ecause Rule 1.7(b) imposes an ongoing obligation to avoid conflicts, the attorney regularly must reexamine the investment for potential conflicts.” Independent Lawyer Report, p. 43. [DISCUSS DISCLOSURE REQUIREMENTS]

**A. Can Lawyer Advise Individual Shareholders?**

A lawyer for an organization does not automatically represent its individual principals; the lawyer and the relevant individuals must agree to the representation. Generally, a lawyer may advise and represent both the company and individual shareholders “subject to the provisions of rules 1.7, 1.8.2, 1.8.6, and 1.8.7. If the organization’s consent to the dual representation is required by any of these rules, the consent shall be given by an appropriate official, constituent, or body of the organization other than the individual who is to be represented, or by the shareholders.” . Rule 1.13(g). To the extent the interests of the individual shareholders actually conflict under rule 1.7(a) or there is a significant risk that Lawyer’s representation of one shareholder may be materially limited by their responsibilities to another shareholder under rule 1.7(b), Lawyer must explain to each client in writing the relevant circumstances and material risks, including any actual and reasonably foreseeable consequences, and obtain each client’s informed written consent to the joint representation. A direct or material limitation conflict could arise, for example, where stock ownership is comprised of majority and minority shareholders or where they value different interests in contemplating the sale. If Lawyer reasonably believes that they cannot provide “competent and diligent representation to each affected client.” Lawyer should not take on the representation and advise the shareholders that they each should consult independent counsel concerning their individual interests in whether to agree to the deal and if so, the particular deal terms.

**B. If Lawyer Declines to Advise Individual Shareholders, Does Lawyer Have Any Duties of Disclosure?**

Lawyer’s professional obligations run to the corporate entity and not to the individual shareholders. However, Lawyer has a duty not to mislead the shareholders and must explain to them that Lawyer represents the Company and not the individual shareholders. CRPC 1.13(f); see also, CRPC 4.3(a) [lawyers have a duty to correct an unrepresented person’s misunderstanding that the lawyer is disinterested.] Furthermore, “Lawyer must refrain from taking part in controversies or factional

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407 differences among shareholders so that they can advise the corporation without bias or prejudice.”  
408 [FROM RUTTER 4:89 – REWORD] *Goldstein v. Lees* (1975) 46 Cal.3d 614, 622; *Ward v. Sup. Ct.* (1977) 70  
409 Cal.App.3d 23, 32-34; Cal.State Form. Opn. 1994-137.

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## CONCLUSION

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### IN-HOUSE COUNSEL DRAFT OPINION

#### ISSUES:

(1) What are the conflict of interest duties of an in-house lawyer when moving from one company to another?

(2) What conflicts of interest are presented by a stock option agreement between in-house lawyer and the company?

(3) What conflicts on interests arise from in-house lawyer's representation of company shareholders in connection with proposed acquisition by a third party via a stock purchase transaction where lawyer is a shareholder of company?

#### DIGEST:

[INSERT]

#### AUTHORITIES

#### INTERPRETED:

Rules of Professional Conduct 1.0.1, 1.7, 1.8.1, 1.9, 1.10, 1.13

### STATEMENT OF FACTS AND QUESTIONS PRESENTED

After practicing law for 5 years as in-house legal counsel for a software company ("Old Company"), Lawyer has decided to take a position as General Counsel for a closely-held software company ("Company"), owned by three shareholders ("Shareholders"). The Shareholders make up the Board of Directors ("Board"). Lawyer is expected to head a small team of three lawyers ("Legal Department"). There are approximately 75 salaried employees who own stock and/or stock options.

Company is a competitor of Old Company in that the software they both ~~are in the process of registering competing patents for~~ sell uses similar technology protected through a number of patents and other intellectual property rights. . Old Company is publicly held, with several divisions. Old Company has a central legal department managed by a General Counsel. The legal department was segregated into teams. Lawyer was assigned to the labor and employment team. Lawyer was not part of the team that advised Old Company concerning its technology and patent applications. However, Lawyer ~~was responsible for advising Old~~ will be expected to advise Company on all legal issues ~~concerning its business strategies, including those relating to Company's technology~~ and ~~marketing, which necessarily involved patented products.~~ patent applications.

**Question 1:** *Before formally accepting the position, Lawyer wants to know how to analyze and navigate any potential conflicts that Lawyer might have based on Lawyer's work at Old Company and to what extent an ethical screen may be required.*

As part of Lawyer's employment agreement with the Company, Lawyer is presented with a stock option agreement that is offered to the Company's key employees. The agreement states that Lawyer has an option to purchase a certain number of shares of the Company's common

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stock at an exercise price equal to the fair market value of such shares on the date of the grant, based on the Company's Stock Incentive Plan. The agreement also states that the securities will vest over time, at increasing percentages over the course of five years. The agreement also states that in the event of a merger with or acquisition by another company, the vesting of the Lawyer's option will immediately accelerate so as to become fully vested.

**Question 2:** *Lawyer wants to know whether the stock option agreement presents any conflicts of interest, and if so, how and when such conflicts of interest should be addressed with the Company.*

Lawyer begins working for Company. Three years later, after Lawyer's securities are 30% vested, Company begins talks with another Company (Public Company) under which Public Company offers to acquire Company through a stock purchase and Company would become a wholly-owned subsidiary of Public Company. Company's CEO asks Lawyer to advise the Shareholders (i.e., the sellers under the proposed deal) about the benefits and risks of the proposed deal, and potential negotiation terms including a sales price.

**Question 3:** *Lawyer wants to know whether her status as a stockholder in the Company presents a conflict of interest in connection with the requested advice, and if so, whether the conflict may be waived by the Company. Lawyer also wants to know whether the requested advice to the Shareholders will present conflicts of interest between and among the Shareholders and/or between the Shareholders and the Company. Lawyer also wants to know whether she may ethically represent Company in direct negotiations with Public Company and/or its counsel.*

## DISCUSSION

Generally, the California Rules of Professional Conduct (CRPC) apply equally to in-house lawyers who are licensed or registered<sup>1</sup> in California to practice law, and all other California lawyers. In-house lawyers have attorney-client relationships with the organizations that employ them. *Gutierrez v. G & M Oil Co., Inc.* (2010) 184 Cal.App.4<sup>th</sup> 551, 559. An organization's legal department is encompassed within the definition of "law firm" under the rules. Rule 1.0.1(c) ("Firm" or "law firm" means . . . lawyers employed in a legal services organization or in the legal department, division or office of a corporation, of a government organization, or of another organization.") A lawyer's duties to an organizational client are the same whether they are "employed or retained" by the organization. [Rule CRPC 1.13\(a\)](#). The underlying purposes of a lawyer's fiduciary duties – protecting the public and the integrity of the legal system and promoting the administration of justice and confidence in the legal profession – are not diminished simply because the lawyer is employed rather than retained by an organizational client.

However, the nature of an in-house lawyer's fiduciary duties may be relative to the nature of the attorney-client relationship between employer and employee. "For example, in-house lawyers may be seen to owe different duties than independent lawyers, perhaps because they are viewed as employees of the client directly rather than indirectly." Klein, No Fool for a Client: The Finance and Incentives Behind Stock-Based Compensation for Corporate Attorneys, 1999 Colum. Bus. L. Rev. 330. Accordingly, "[t]he dual status of in-house counsel—acting as both employee and attorney—and the dual status of

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<sup>1</sup> See, California Rules of Court (CRC) 9.46 (Registered In-House Counsel).

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the company—acting as both employer and client—can pose some challenging questions about when one role takes precedence over another.” *Missakian v. Amusement Industry, Inc.* (2021) 69 Cal. App. 5th 630, 652; *see also, General Dynamics Corp. v. Superior Court (Rose)* (1994) 7 Cal.4th 1164 (recognizing this dynamic in the employment law context).

Potential conflicts of interest arising from an in-house lawyer’s movement from one in-house position to another and an in-house lawyer’s ownership of stock or stock options in their employer present such challenging questions. As explained below, although the CRPC apply with equal force to in-house lawyers as they do to independent lawyers, the application of the relevant rules, must be analyzed in the context of both the attorney-client and employer-employee relationships at issue.

## APPLICATION

### I. What is the Scope of Lawyer’s Duties To Their Former Employer, Old Company?

~~The California Rules of Professional Conduct (and Model Rules of Professional Conduct) are typically directed at lawyers practicing at law firms, so in-house lawyers must consider the purpose of each rule as it applies to their practice.~~ As discussed above, an in-house lawyer ~~(a lawyer “employed or retained by an organization”)~~ represents the organization itself as a client. ~~(CRPC 1.13(a)-).~~ Thus, Lawyer’s ~~previous~~former client was Old Company, and Lawyer’s current client is Company, ~~acting through its authorized constituents. Keeping in mind who.~~ The question of whether a conflict of interest exists between Old Company and Company is ~~the~~ governed by CRPC 1.9.

CRPC 1.9(a) prohibits representation of a client—whether, including an organization, whose interests are materially adverse to those of the lawyer’s former employer if the lawyer personally represented the former client in the same or substantially related matter. CRPC 1.9(b) applies to situations where the legal department (a “law firm”) represented the former client in the same or ~~current—is~~ important ~~substantially related matter and though the lawyer was not personally involved in analyzing potential conflicts,~~ the representation, the lawyer did obtain confidential information that is material to the prospective employer’s matter. Informed written consent from the former client is required if either CRPC 1.9(a) or 1.9(b) (or both) applies to a particular situation, unless the elements of CRPC 1.10’s screening requirements are satisfied, as discussed below.

Irrespective of whether CRPC 1.9(a) or (b) applies, CRPC 1.9(c)(1) and (2) prohibits the use and disclosure of confidential information unless certain exceptions apply or the information has become “generally known.”

#### A. CRPC 1.9(a) – Lawyer’s Personal Representation of Old Company

“When . . . a former in-house lawyer is sought to be retained by a client for a matter adverse to his former corporate client, the lawyer must ask and answer four questions: (1) whether the lawyer represented his former employer in the matter in question; (2) if so, whether the matter the new client has asked him to undertake is the same matter as, or is substantially related to, the matter in which he represented his former employer; (3) if the matters are either the same or substantially related, whether the interests of his new client are materially adverse to those of his former employer; and (4), if the answers to all of the above questions are yes, whether his former employer has consented to his undertaking the new representation.” ABA Form. Opn. 99-415.

## 1. Personal Representation

A threshold requirement of CRPC 1.9(a) is that the lawyer must have personally represented the former client in the matter that is the same or substantially related to the prospective client's matter. "The determination whether a lawyer 'represented' his former employer with respect to a matter requires inquiry into the responsibilities of the lawyer during his former employment." ABA Form. Opn. 99-415. Moreover, "[a] distinction may be made between a lawyer who has been heavily involved in a matter and one who has dealt with issues and not with factual analysis."

Here, Lawyer was not part of the team that advised Old Company concerning its technology and patent applications. ~~and other~~ Instead, Lawyer advised Old Company on labor and employment issues. Thus, similar to a law firm lawyer who worked in a particular practice group and was not involved in the representation of firm clients on matters handled by lawyers in a different practice group, Lawyer's handling of labor and employment issues does not establish that Lawyer personally representation Old Company regarding its patents and technology. This is true even if Lawyer's advice to, and representation of, Old Company related to employees who worked on Old Company's technology and patents. To the extent Lawyer acquired confidential information in the process, CRPC 1.9(b) and (c) governs Lawyer's duties ~~ver~~ and conduct.

## 2. "Same or Substantially Related" Matters

Two matters are "the same or substantially related" if they involve a substantial risk of a violation of the duty of loyalty or the duty of confidentiality (or both). CRPC 1.9, Comment [3].

~~A lawyer owes two duties~~ The duty of loyalty to a former client: ~~a duty of loyalty (to~~ means that the lawyer must refrain from doing "anything that will injuriously affect the former client in any matter<sup>2</sup> in which the lawyer represented the former client"; ~~and a.~~ CRPC 1.9, Comment [3]. The duty of confidentiality ~~(to~~ a former client means that the lawyer must refrain from ~~ever~~ using against the former client "knowledge or information acquired by virtue of the previous relationship." ~~(.)~~ CRPC 1.9, Comment [1] ~~to Rule 1.9 [1]~~, citing *Oasis West Realty, LLC v. Goldman* (2011) 51 Cal.4th 811, and *Wutchumna Water Co. v. Bailey* (1932) 216 Cal. 564[.].

~~Alawyer must obtain informed written consent from a former client before representing another client "in the same or a substantially related matter" in which the current client's interests are "materially adverse" to the former client's interests (Rule 1.9(a)).~~ Examples of matters that are the same or substantially related include: ~~"(Two matters are "the same or substantially related" if they involve a substantial risk of a violation of the duty of loyalty or the duty of confidentiality (or both). CRPC 1.9, Comment [3]. "For example, this will occur: (i) if the matters involve the same transaction or legal dispute or other work performed by the lawyer for the former client; or (ii) if the lawyer normally would have obtained information in the prior representation that is protected by Business and Professions Code section 6068, subdivision (e) and rule 1.6, and the lawyer would be expected to use or disclose that information in the subsequent representation because it is material to the subsequent representation." Ibid.~~

<sup>2</sup> [DEFINITION OF MATTER] CRPC 1.7(e) For purposes of this rule, "matter" includes any judicial or other proceeding, application, request for a ruling or other determination, contract, transaction, claim, controversy, investigation, charge, accusation, arrest, or other deliberation, decision, or action that is focused on the interests of specific persons, or a discrete and identifiable class of persons.



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Thus, rule 1.9(a) “prohibits a lawyer from representing a person whose interests are materially adverse to those of his former employer if he personally represented the former employer in the same or substantially related matter

The fact that Old Company and Company are competitors with similar technologies and patents is insufficient alone to establish that Lawyer represented Old Company in the same or substantially related matter to the matter or matters that Lawyer is expected to handle at Company. Such a conclusion would effectively force lawyers to start anew each time they change jobs, drastically restricting their mobility. Indeed,” ~~ABA Form. Opn. 99-415. Furthermore, even if the lawyer did not personally represent the former employer in the same or a substantially related matter, “if others in the legal department did, and the former in-house lawyer acquired protected information during his employment that is material to the prospective client’s matter,” the same prohibitions under rule 1.9(a) apply. CRPC 1.9(b); ABA Form. Opn. 99-415. Finally, as with any former client, an in-house lawyer is prohibited from using or disclosing their “former employer’s protected information (unless it is generally known) . . . even if the lawyer is not adverse to the former client or the adversity is in a matter that is not substantially related to the prior representation.” Ibid.~~

For an in-house lawyer who provided legal advice to a company concerning a broad range of matters, the question of whether representation of a new company is considered “the same or [] substantially related” is a more difficult question than a lawyer performing legal work at a law firm on a case, matter, or transaction basis. The Second Circuit test of “substantially related” matters—requiring demonstration of either (1) a “patently clear” relationship between the issues in the prior and present representations, or (2) that the issues are “identical” or “essentially the same”—offers little guidance here. (Gov’t of India v. Cook Inds., Inc. (2nd Cir. 1978) 569 F.2d 737, 739-40.) [REPLACE WITH CA LAW AND EXPAND ANALYSIS]

~~Here, Lawyer was not part of the team that advised Old Company concerning its technology and patent applications. Instead, Lawyer advised Old Company generally on legal issues, including its business strategies and marketing, and will certainly advise Company on similar matters as head of a small legal team. Lawyer’s legal advice to Old Company on its business strategies and marketing necessarily involved patented products.~~

General legal advice is too broad to be considered a “matter”—to do so would necessitate the conclusion that every matter undertaken by an in-house lawyer is substantially similar to every other one, and the result would be a duty of extra loyalty to the detriment of a lawyer’s career mobility. Lawyers’ mobility—and ability to leverage the expertise and knowledge gained along their career path—is increasingly important. (See ABA Form. Opn. 99-415 at 2 [“The increased frequency with which lawyers employed by an organization are hired by a competitor or by a law firm seeking the expertise gained by the lawyer in his former position has resulted in a greater focus on [the issue of in-house lawyers’ duties to former clients].”].)

However, the “same or substantially related” standard may be met where the two representations involve competing patents. See e.g., *Nasdaq, Inc. v. Miami Int’l Holdings, Inc.* (2018) 2018 U.S. Dist. LEXIS 151813 (law firm disqualified from representing new client against former client in patent infringement case because “[a]ll of the patents at issue in this case relate to ‘methods and systems for automated securities trading, including options trading,’ and the accused technology is the same for all asserted patents.”)

### 3. Material Adversity

Application of CRPC 1.9(a) not only requires that the lawyer must have personally represented the former client in a matter that is the same or substantially related to the matter for the prospective client, but that the former and prospective clients’ interests are materially adverse. CRPC 1.9(a) and its comments do not define material adversity for purposes of the rule. However, “[since 2000] regulatory authorities, and ethics scholars have interpreted the meaning of ‘material adverseness’ in [ABA Model] Rule 1.9. These authorities have generally concluded that ‘material adverseness’ includes, but is not limited to, matters where the lawyer is directly adverse on the same or a substantially related matter. While material adverseness is present when a current client and former client are directly adverse, material adverseness also can be present where direct adverseness is not.” ABA Form.Opn. 497-21. “However, ‘material adverseness’ does not reach situations in which the representation of a current client is simply harmful to a former client’s economic or financial interests, without some specific tangible direct harm.” *Ibid.* On the other hand, the general nature of an in-house lawyer’s work does not create a shield such that an in-house lawyer will have no conflicts and owes no duty to former lawyers. Instead, Lawyer must evaluate the extent and nature of confidential information learned in Lawyer’s former employment that would be material to the new matter. (See 1.9, Comment [3], noting that a lawyer with confidential information would be expected to use or disclose that information in a substantially similar matter.) Although Lawyer’s prior general legal advice involved Old Company’s patented products, the facts do not suggest that the advice included patent applications or implicated specialized patent law issues that are substantially related to Company’s pending patent registration. The general legal advice alone, would not be considered a substantially related matter just because it involved Old Company’s patented products, unless Lawyer acquired confidential information from the prior advice that would be material to the Company’s patent registration.

Even if a matter is not substantially related and a lawyer does not have confidential information within the meaning of Business and Professions Code section 6068, subdivision (e) and rules 1.6 and 1.9(c), a lawyer may have gained extensive knowledge of a company’s strategies, policies and tendencies (or specific facts, like its financial situation).

Likewise

However, similar to the analysis above regarding the substantial relationship, knowledge of a company’s “playbook” alone is not enough to disqualify a lawyer based on the duty of loyalty; instead, there must be a showing that the information gained from the “playbook” is of “critical importance” to the matter at hand. (See *Fremont Indem. Co. v. Fremont Gen. Corp.* (2006) 143 Cal.App.4th 50, 65.)

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Here, ~~no facts~~ suggest that Lawyer gleaned information from Old Company's "playbook" regarding its technology or patent applications that would rise to the level of ~~material~~ importance; thus, absent additional facts about confidential information, the competing nature of the two companies and the similarity of Lawyer's roles at the two companies does not mean that Lawyer has violated ~~the duties~~the duties of loyalty or confidentiality to Old Company by accepting employment at Company.<sup>3</sup>

~~DR- capture no conflict/duty to screen, in house counsel discussing with outside counsel~~ ~~KR- More case law about not substantially related~~ ~~BK- Screens might not be possible under certain circumstances~~

However, material adverseness may arise in the future to the extent Lawyer is required to attack the work performed Old Company. ABA Form.Opn. 497-21: "Another type of "material adverseness" exists when a lawyer attempts to attack her own prior work. For example, one court held that a lawyer cannot challenge a patent that the lawyer previously obtained for a former client." See also, Oasis West Realty, LLC v. Goldman (2011) 51 Cal. 4th 811 (lawyer should not have lobbied against project that he earlier worked on).

### 4. Informed Written Consent

#### B. CRPC 1.9(b)

Even if CRPC 1.9(a) does not apply, Lawyer may still may be disqualified from serving as Company's General Counsel if Lawyer acquired protected information that is material to the matters he is expected to handle in that role. "Depending on the size and structure of the legal department and the extent to which it limits access to confidential information to those lawyers working on a matter, the lawyer may have obtained information as the result of shared confidences, requiring disqualification under Rule 1.9(b)." ABA Form.Opn. 415-97.

#### C. CRPC 1.9(c)

Even if Lawyer determines that no conflict of interest exists under CPRP 1.9(a) or (b), Lawyer must still maintain inviolate Old Company's confidential information under CRPC 1.9(c). Nevertheless, CRPC 1.9(c) does not prohibit using information obtained through a prior representation where the information has become "generally known" (or where disclosure is otherwise authorized by the CRPC).

"The fact that information can be discovered in a public record does not, by itself, render that information generally known under paragraph (c). (See, e.g., In the Matter of Johnson (Review Dept. 2000) 4 Cal. State Bar Ct. Rptr. 179.)"

#### D. CRPC 1.10 – Screening

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<sup>3</sup>~~Insert brief discussion re possible screening under CRPC 1.10?~~ ~~DR- capture no conflict/duty to screen, in house counsel discussing with outside counsel~~ ~~KR- More case law about not substantially related~~ ~~BK- Screens might not be possible under certain circumstances~~

## REDLINE

Based on the facts presented, there is no initial conflict of interest for Lawyer under CRPC 1.9(a) or (b), and therefore no informed written consent from Old Company is required before Lawyer agrees to accept the General Counsel position with Company. However, given that Old Company and Company are competitors, with similar technology and patents, a conflict of interest may arise in the future. In that event, Lawyer (and Company) may have the option of screening under CRPC 1.10(a)(2). Specifically, the following requirements must be met:

- (1) Lawyer did not substantially participate in the same or substantially related matter;
- (2) Lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom; and
- (3) Written notice is promptly given to Old Company to enable it to ascertain compliance with the provisions of the rule, which shall include a description of the screening; procedures employed; and an agreement by Company to respond promptly to any written inquiries or objections by Old Company about the screening procedures.

It unlikely that Lawyer substantially participated in matters involving Old Company's patents and technology because Lawyer's work was limited to labor and employment. Therefore, screening may be appropriate assuming it is timely implemented with the requisite notice to Old Company. However, Lawyer's position as General Counsel overseeing a legal department of just three lawyers may require that not only must Lawyer be screened from participation in the conflicted matter, but that Company must refer the matter to outside counsel to handle. Outside counsel should report to one of Company's constituents other than Lawyer.

### **What are Lawyer's Ethical Duties Regarding Stock Options Offered by New Company as Compensation for Employment?**

#### **A. Potential Application of CRPC 1.8.1**

In the traditional attorney-client relationship, a lawyer's acceptance of stock or stock options from a client in lieu of fees for legal services is subject to ~~rule~~CRPC 1.8.1, which governs when a lawyer knowingly acquires an ownership or other pecuniary interest adverse to a client. ~~See Rule~~See CRPC 1.8.1, Comment [5] ("This rule does not apply to the agreement by which the lawyer is retained by the client, unless the agreement confers on the lawyer an ownership, possessory, security, or other pecuniary interest adverse to the client."); ABA Formal Opn. 00-418 ("[A] lawyer who acquires stock in her client corporation in lieu of or in addition to a cash fee for her services enters into a business transaction with a client, such that the requirements of Model Rule 1.8(a) must be satisfied."). If ~~rule~~CRPC 1.8.1 applies, the lawyer must ensure that the following requirements are met:

- (a) the transaction or acquisition and its terms are fair and reasonable to the client and the terms and the lawyer's role in the transaction or acquisition are fully disclosed and transmitted in writing to the client in a manner that should reasonably have been understood by the client;
- (b) the client either is represented in the transaction or acquisition by an independent lawyer of the client's choice or the client is advised in

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writing\* to seek the advice of an independent lawyer of the client's choice and is given a reasonable opportunity to seek that advice; and

(c) the client thereafter provides informed written consent to the terms of the transaction or acquisition, and to the lawyer's role in it.

The purpose of the rule is to address the inherently imbalanced relationship between attorney and client.

*Beery v. State Bar* (1987) 43 Cal.3d 802, 812-813, quoting, *Felton v. Le Breton* (1891) 92 Cal. 457, 469 [28 P. 490], and citing, *Estate of Witt* (1926) 198 Cal. 407, 419; *Gold v. Greenwald* (1966) 247 Cal. App. 2d 296, 305-306. "The law accordingly takes a jaundiced view of business transactions between attorneys and their clients." *Ferguson v. Yaspan* (2014) 233 Cal.App.4th 676, 685. Indeed, "the law presumes" attorneys engaging in such transactions "wear" a "black" hat. *Mayhew v. Benninghoff* (1997) 53 Cal.App.4th 1365, 1369.<sup>4</sup>

However, these concerns are typically absent in the in-house context, where the new lawyer is offered the same general compensation terms, including stock and stock options, as those offered to other key employees. Indeed, the power dynamic may be reversed. [F]rom an economic standpoint, the dependence of in-house counsel is indistinguishable from that of other corporate managers or senior executives who also owe their livelihoods and career goals and satisfaction to a single organizational employer." *General Dynamics Corp. v. Superior Court*, *supra* 7 Cal. 4th at 1172. In addition, the in-house lawyer's employment agreement may be prepared and/or presented by the General Counsel, employment counsel, or other company counsel.

In *Chism v. Tri-State Construction Inc.* (2016) 193 Wn.App. 818, a Washington state court of appeals addressed application of Washington State's version of rule 1.8.1, in the in-house context.<sup>5</sup> There, Mr. Chism, Tri-State Construction Inc.'s (Tri-State) general counsel, sued Tri-State for breach of compensation contracts to recover allegedly unpaid bonuses, which were drafted by Mr. Chism and negotiated during his tenure as general counsel. The court of appeals reversed the trial court's decision finding that the agreements to pay bonuses to Mr. Chism constituted modifications of his original

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<sup>4</sup> A lawyer's failure to satisfy the requirements of rule 1.8.1 subjects a lawyer to discipline. However, a violation of the rule does not by itself provide a basis for civil liability. Rather, the rule's "statutory counterpart—Probate Code section 16004—erects a presumption that transactions between an attorney and client 'by which the [attorney] obtains an advantage' are a breach of the attorney's fiduciary duty and are the product of undue influence." *Ferguson v. Yaspan*, *supra*, at 684-685; see also, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135, 1140. "The presumption is rebuttable, and the attorney's inability to do so renders the transaction voidable at the client's option." *Ferguson v. Yaspan*, *supra* at 685.

<sup>5</sup> Washington State Bar Rule of Professional Conduct [RPC] 1.8 provides, in pertinent part:

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of an independent lawyer on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

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employment agreement and thus were subject to RPC 1.8(a). 193 Wn.App. 818, 852. In so holding, the court of appeal reasoned that [SB adding footnote making distinctions b/w circumstances; offer vs. atty-client relationship]

The trial court's conclusions regarding these agreements gloss over the essential differences between fee agreements and wage contracts. Under the trial court's interpretation of the rule, every compensation agreement entered into between a lawyer-employee and a current client-employer would be subject to RPC 1.8(a). This would include, for example, every agreement increasing a lawyer-employee's wages or benefits. . . . By rendering [the] compensation agreements prima facie fraudulent, the trial court's interpretation would disturb the settled expectations of many lawyer-employees. It would also subject standard wage contracts for lawyer-employees, which frequently include nonmonetary compensation, to greater scrutiny overall than standard fee contracts, which are generally exempt from the rule. Moreover, it would do this without addressing whether lawyer wage contracts should be exempt from the rule as another type of "transaction [in which] the lawyer has no advantage in dealing with the client," RPC 1.8 cmt. 1, given that, in general, employees are thought to have relatively little power compared with that of their employers. Cf. *Rickman v. Premera Blue Cross*, 184 Wn.2d 300, 309, 358 P.3d 1153 (2015) (stating, regarding the wrongful termination cause of action, "allowing an exception to the at-will doctrine serves to equalize the imbalance of power that exists in an employment relationship").

*Chism v. Tri-State Construction Inc.*, *supra*, 193 Wn.App. 818, 853. See also, Washington State Bar Association Advisory Opinion:

A lawyer negotiated with corporate management over an employment contract to serve as legal counsel. The contract provided that part of the lawyer's compensation would be shares in the publicly traded corporation. The Committee was of the opinion that negotiations as described by you in working out an employment contract for the full time job of legal counsel for a corporation does not violate RPC 1.8. It appeared to be an arm's length transaction, and it did not appear that you were in any way giving legal advice to the corporation.

In other words, the Washington State Bar and court of appeals take the position that when placed in the employment context, the in-house lawyer's initial employment agreement containing stock grants or options, as well as subsequent adjustments to the lawyer's salary or "wages," are substantively similar to a typical attorney fee agreement, which is presumed to be an arms-length transaction. <sup>6</sup>

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<sup>6</sup> See, rule 1.8.1, Comment [5]: "This rule does not apply to the agreement by which the lawyer is retained by the client, unless the agreement confers on the lawyer an ownership, possessory, security, or other pecuniary interest

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The ABA Task Force on the Independent Lawyer ["Task Force"] in its report, *Lawyers Doing Business with Their Clients: Identifying and Avoiding Legal and Ethical Dangers* 56 (2001) [hereafter "Independent Lawyer Report"] reached a similar conclusion: "In the usual case, the receipt of equity-based compensation by in-house counsel would not appear to be the type of "business transaction with a client" contemplated by Rule 1.8. Option or restricted stock grants (the usual forms of equity compensation paid to in-house attorneys) are merely a form of compensation and, like cash, are a facet of the general employment relationship rather than part of or related to any particular transaction or undertaking." The Task Force noted that the "timing, size and conditions" placed on stock grants are typically the result of unilateral decisions by the corporate employer, in consultation with outside advisors and counsel. In short, the Task Force concluded, such stock grants, under normal circumstances, should not create interests that are "adverse" to the company's interests.

However, a distinction must be made between an employment agreement offered by an established company that contains stock grants or options as a general form of employment compensation to the potential in-house attorney, and other types of business transactions ~~with a potential or existing client~~ in which ~~the~~there is an inherent imbalance of power between attorney, ~~who serves as in-house counsel or corporate counsel for the client, is afforded stock grants or options~~ and client. For example, Rule 1.8.1 applies to situations where the attorney and an existing or new client form a business together as owners or shareholders, and the attorney provides legal services to the newly-formed business entity.<sup>7</sup> See, *Fair v. Bakhtiari* (2011) 195 Cal.App.4th 1135-, \_\_\_\_.

Likewise, an in-house attorney for an existing entity is required to comply with Rule 1.8.1 where stock ~~ownership is offered~~taken or increased as part of a specific transaction or undertaking rather than as part of the initial employment agreement ~~or periodic performance reviews.~~ Passante v. McWilliam (1997) 53 Cal. App. 4th 1240 is instructive. There, the company was in need of capital and the company's corporate lawyer had arranged additional funding. The "grateful board" promised three percent of company stock to the lawyer. The lawyer sued the company after its board reneged on the promise. The court held that the lawyer was required to comply with former rule 3-300 given the lawyer's fiduciary relationship with the company as its corporate lawyer who should have given "all that reasonable advice against himself that he would have given him against a third person." *Passante v. McWilliams, supra*, 53 Cal.App.4<sup>th</sup> 1240, ~~1248~~-(\_\_\_\_) (internal quotations and citations omitted). Had he done so,

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adverse to the client." See also, rule 1.8.1, Comment [6] "This rule does not apply . . . to standard commercial transactions for products or services that a lawyer acquires from a client on the same terms that the client generally markets them to others, where the lawyer has no advantage in dealing with the client." Wa. RPC 1.8(a), Comment [1] is similar: "[RPC 1.8(a)] does not apply to ordinary fee arrangements between client and lawyer, which are governed by Rule 1.5, although its requirements must be met when the lawyer accepts an interest in the client's business or other nonmonetary property as payment of all or part of a fee. In addition, the Rule does not apply to standard commercial transactions between the lawyer and the client for products or services that the client generally markets to others, for example, banking or brokerage services, medical services, products manufactured or distributed by the client, and utilities' services. In such transactions, the lawyer has no advantage in dealing with the client, and the restrictions in paragraph (a) are unnecessary and impracticable."

<sup>7</sup> It is irrelevant that the lawyer is not formally designated as "general counsel" or "in-house counsel" for the business entity, or whether the lawyer provides both legal and nonlegal services. "When a member performs both legal and non-legal professional services for a client, the member is subject to the California Rules of Professional Conduct with respect to all of those services." Cal. Form. Opn. 1999-154.



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“[i]ndependent counsel would likely have at least reminded the board members of the obvious—that a grant of stock to Passante might complicate future capital acquisition.” ~~*ibid.*~~

Factors to consider in determining whether CRPC 1.8.1 applies to an in-house lawyer’s compensation include (1) whether the lawyer was involved in advising on the organization’s formation; (2) whether the proposed compensation agreement is drafted and proposed by the organization (or its counsel) or the lawyer; (3) whether the organization has independent counsel concerning the compensation agreement; (4) whether the compensation terms offered to the lawyer are substantively similar to those offered to employees at the same level. [OTHERS?]

Here, Lawyer is presented with a stock option agreement that is offered to the Company’s key employees as part of the Company’s Stock Incentive Plan. The securities vest incrementally over time. Thus, stock options are offered as a standard form of compensation in the proposed employment agreement and not in connection with a particular transaction or undertaking. It is an arms-length transaction that does not trigger the requirements under rule 1.8.1.

~~[SUMMARY]~~

] JF: Refine, reach out to other jurisdictions/ABA to support argument, CC: 1.5 applies to compensation agreements? Address where 1.5 goes/footnote

### B. Potential Application of CRPC 1.7

Lawyer must separately consider whether the stock option provisions in the employment agreement present a “material limitation” conflict of interest under rule 1.7(b). Specifically, rule 1.7(b) prohibits representation of a client if the representation “may be materially limited . . . by the lawyer’s own interests,” without the informed written consent of the client. Further, the lawyer cannot represent the client even with the requisite consent from the client if the lawyer does not “reasonably believe[] that the lawyer will be able to provide competent and diligent representation to each affected client.” Rule 1.7(d)(1). Thus, where the lawyer has a personal interest in the subject matter of the representation, the lawyer must assess whether their independent judgment will be materially impacted to the detriment of the client. See, e.g., Model Rule 1.7, Comment [10]: “For example, if the probity of a lawyer’s own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. . . . See Rule 1.8 for specific Rules pertaining to a number of personal interest conflicts, including business transactions with clients.”

In ABA Formal Opn. 00-418, the Committee opined that although issuance of stock to outside counsel in lieu of fees mandated compliance with Model Rule 1.8(a) (the equivalent to CRPC 1.8.1), it “creates no inherent conflict of interest” under the “material limitation” conflict provisions of Model Rule 1.7(b). The Committee explained: “Indeed, management’s role primarily is to enhance the business’s value for the stockholders. Thus, the lawyer’s legal services in assisting management usually will be consistent with the lawyer’s stock ownership. In some circumstances, such as the merger of one corporation in which the lawyer owns stock into a larger entity, the lawyer’s economic incentive to complete the transaction may even be enhanced.” Nevertheless, the Committee also cautioned that particular circumstances may dictate compliance ~~with Model Rule 1.7(b):~~

For example, the lawyer might have a duty when rendering an opinion on behalf of the corporation in a venture capital transaction to call upon



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corporate management to reveal material adverse financial information that is being withheld, even though the revelation might cause the venture capital investor to withdraw. In that circumstance, the lawyer must evaluate her ability to maintain the requisite professional independence as a lawyer in the corporate client's best interest by subordinating any economic incentive arising from her stock ownership. The lawyer also must consider whether her stock ownership might create questions concerning the objectivity of her opinion. She must consult with her client and obtain consent if the representation may be materially limited by her stock ownership.

The conflict could be more severe. For example, the stock of the client might be the lawyer's major asset so that the failure of the venture capital opportunity could create a serious financial loss to her. The lawyer's self-interest in such a case probably justifies a reasonable belief that her representation of the corporation would be affected adversely. This would disqualify her under Rule 1.7(b) from providing the opinion even were the client to consent. CC: When 1.7 conflict waiver would be required

However, this does not render rule 1.7(b) wholly inapplicable to an in-house lawyer who owns stock or stock options. *See also*, Independent Lawyer Report, p. 56 ("To the extent . . . that the receipt of such compensation or the ownership of equity in the employer company might raise a question as to a potential conflict of interest or impairment of the representation, Rule 1.7 would govern.")

~~Company's offer of stock options as part of its Stock Incentive Plan itself~~ Here, Company offers Lawyer participation in its Stock Incentive Plan, which includes stock options that vest incrementally over time. These are terms offered to other key employees. At the outset of the employment relationship, these provisions by themselves may not present a significant risk that Lawyer's independent judgment will be materially limited to the detriment of the Company. "Given the relatively limited equity stake of corporate counsel in most cases, the lawyer's ownership interest usually would not materially limit the representation. Indeed, equity-based compensation grants generally are made in small increments over time and, at the time made, are restricted in ways that give them only contingent, future value." Independent Lawyer Report, p. 56. ~~In other words, it is not reasonably foreseeable at this early juncture in the employment relationship how Lawyer's future investments may impact their professional judgment in performing a wide variety of legal services on a day-to-day basis. There are no "relevant circumstances" and "material risks, including any actual or reasonably foreseeable adverse consequences of the proposed course of conduct" that Lawyer could explain for which informed consent from Company would be required. CRPC 1.01(e) [definition of "informed consent"].~~

~~The~~ However, the stock option agreement also provides that in the event of a merger with or acquisition by another company, the vesting of the Lawyer's ~~stock options~~ option will immediately accelerate so as to become fully vested. ~~The provision presents a hypothetical upon which Lawyer could possibly envision various scenarios in which Lawyer's professional judgment could be materially and adversely~~

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485 impacted. However, a “mere hypothetical conflict is insufficient;” rather, there must be a “reasonable  
486 likelihood an actual conflict will arise.” *Havasu Lakeshore Investments LLC. v. Fleming* (2013) 217  
487 Cal.App.4<sup>th</sup> 770, 779 [DOUBLECHECK[DOES THIS]. See also, ABA Model Rule 1.7, comment [8]: “The mere  
488 possibility of subsequent harm does not itself require disclosure and consent.” Here, without more  
489 foundational facts such as whether Company intends to entertain a merger or acquisition deal, the  
490 imminency and potential terms of the deal, and the percentage of Lawyer’s assets representing  
491 Company stock once fully vested, among other unknown factors, a “material limitation” conflict is not  
492 ~~reasonably foreseeable.~~ TRIGGER COMPLIANCE AT THE TIME OF THE AGREEMENT OR ONLY WHEN THE  
493 TRIGGERING EVENT HAPPENS?

494  
495 Accordingly, the proposed employment agreement containing the stock option provisions do not  
496 present a rule 1.7(b) “material limitation” conflict of interest requiring informed written consent from  
497 Company before Lawyer takes the job.

### 505 **III.II. Question 3: What are Lawyer’s Ethical Duties to New Company and the Individual** 506 **Shareholders Concerning the Sale?**

507 ~~Three years into Lawyer’s role as in-house counsel, when Lawyer’s stock options are 30% vested,~~  
508 ~~acquisition of Company by Public Company is a foreseeable reality and no longer a hypothetical. Thus, at~~  
509 ~~this juncture, Lawyer is required to assess whether their ownership interests present a significant risk~~  
510 ~~that their independent judgment in providing advice to Company about the sale will be materially~~  
511 ~~limited.~~ “[B]ecause Rule 1.7(b) imposes an ongoing obligation to avoid conflicts, the attorney regularly  
512 must reexamine the investment for potential conflicts.” Independent Lawyer Report, p. 43. ~~[DISCUSS~~  
513 ~~DISCLOSURE REQUIREMENTS~~ Three years into Lawyer’s role as in-house counsel, their stock options are  
514 30% vested. Furthermore, Lawyer’s stock options will be treated as fully vested in the acquisition  
515 negotiations. These are the type of circumstances that rise to the level of a 1.7(b) conflict, requiring  
516 informed consent from the Company before Lawyer advises it about the propriety and terms of the  
517 potential acquisition deal. Lawyer should explain to Company [INSERT]

518  
519 Indeed, if Lawyer’s fully vested stock options comprise of a significant portion of Lawyer’s assets, it may  
520 be unreasonably difficult, if not impossible, for Lawyer to give detached advice to Company. In that  
521 event, Lawyer should recommend that Company

#### 523 **A. Can Lawyer Advise Individual Shareholders?**

524 ~~A lawyer for an organization does not automatically represent its individual principals; the lawyer and~~  
525 ~~the relevant individuals must agree to the representation. Generally, a lawyer may advise and represent~~  
526 ~~both the company and individual shareholders “subject to the provisions of rules 1.7, 1.8.2, 1.8.6, and~~  
527 ~~1.8.7. If the organization’s consent to the dual representation is required by any of these rules, the~~

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consent shall be given by an appropriate official, constituent, or body of the organization other than the individual who is to be represented, or by the shareholders.” Rule 1.13(g). To the extent the interests of the individual shareholders actually conflict under rule 1.7(a) or there is a significant risk that Lawyer’s representation of one shareholder may be materially limited by their responsibilities to another shareholder under rule 1.7(b), Lawyer must explain to each client in writing the relevant circumstances and material risks, including any actual and reasonably foreseeable consequences, and obtain each client’s informed written consent to the joint representation. A direct or material limitation conflict could arise, for example, where stock ownership is comprised of majority and minority shareholders or where they value different interests in contemplating the sale. If Lawyer reasonably believes that they cannot provide “competent and diligent representation to each affected client.” Lawyer should not take on the representation and advise the shareholders that they each should consult independent counsel concerning their individual interests in whether to agree to the deal and if so, the particular deal terms.

Generally, a lawyer may advise and represent both the company and individual shareholders provided the proper disclosures are provided and consent is given by each client. Rule 1.13(g).

### **B. If Lawyer Declines to Advise Individual Shareholders, Does Lawyer Have Any Duties of Disclosure?**

Lawyer’s professional obligations run to the corporate entity and not to the individual shareholders. However, Lawyer has a duty not to mislead the shareholders and must explain to them that Lawyer represents the Company and not the individual shareholders. CRPC 1.13(f); see also, CRPC 4.3(a) [lawyers have a duty to correct an unrepresented person’s misunderstanding that the lawyer is disinterested.] Furthermore, “Lawyer must refrain from taking part in controversies or factional differences among shareholders so that they can advise the corporation without bias or prejudice.” [FROM RUTTER 4:89 – REWORD] *Goldstein v. Lees* (1975) 46 Cal.3d 614, 622; *Ward v. Sup. Ct.* (1977) 70 Cal.App.3d 23, 32-34; Cal.State Form. Opn. 1994-137.

## CONCLUSION