

-Original Message-----

From: Kevin Mohr [mailto:kemohr@comcast.net]
Sent: Tuesday, March 23, 2004 3:11 PM
To: Lamport, Stanley W.
Cc: RRC E-List Group (E-mail); McCurdy, Lauren; Soria, Felicia
Subject: Re: [Rules Commission] RULE 3-600

Greetings:

1. I've reviewed Stan's 2/23/04 draft and am in agreement with the two-tiered approach he suggests for paragraphs (B) and (C), but disagree with what he has done in his paragraph (C). As he drafted (C), he has taken the ABA approach -- requiring that the act be (1) a violation of a legal duty to the corp OR violation of law imputable to the organization; AND (2) likely to result in substantial injury to the organization, before the lawyer's "duty" to go up the ladder is triggered.

2. As currently drafted, rule 3-600 requires either a violation of law OR a substantial injury to the organization (Stan has added the "violation of legal duty to the org" language from MR 1.13, with which I also agree).

3. At the 12/12/03 meeting, nearly all the Commission members then present were comfortable with the idea of a broad trigger for a lawyer to take action (violation of law OR substantial injury) BUT a narrow set of action options (i.e., lawyer can or must go up the ladder WITHIN the organization but may never go OUTSIDE the organization). I think the approach of a broad trigger may have been lost with Stan's proposed paragraph (C).

4. I've made some revisions to Stan's draft in an attempt to capture the thoughts expressed at the 12/12/03 meeting. I've attached Stan's 2/23/04 draft (DFT 2), my revisions (DFT 2.1) and a red-line comparing DFT 2.1 to DFT 2. The clean drafts are in Word. The red-line is in both Word and PDF.

5. I concede my proposed language is inelegant at best, and possibly off the mark as well. Again, I've simply tried to capture what was discussed at the 12/12/ meeting.

a. I realize that as drafted (substantial injury is not tied to a violation of legal duty or law), my para (C) might lead a lawyer to do precisely what Stan fears, i.e., substituting his or her business judgment for the client's (see Stan's 2/19/04 e-mail re 3-600). However, doesn't current 3-600 hold the same threat? ("If a member acting on behalf of an organization knows that an actual or apparent agent of the organization acts or intends or refuses to act in a manner that is or may be a violation of law reasonably imputable to the organization, OR in a manner which is likely to result in substantial injury to the organization," (emphasis added).) That language already allows the lawyer to act even if there is no violation of law. Was it perhaps understood with current 3-600 that it was not intended to reach "substantial injuries" by themselves, but rather

subsumed in the "substantial injury" standard was the agent of the organization's having violated a legal duty? If so, then Stan's draft is closer to capturing that thought than mine.

6. I've also revised some of the language as already agreed to by the Commission at earlier meetings (the Commission decided at an earlier meeting to use the ABA language unless there was a good reason not to do so.) For example:

a. "for" vs. "acting on behalf of"

b. "officer, employee or other person associated with" vs. "apparent agent" (with respect to this, the drafters were charged with coming up with better language than "apparent agent." Some members were concerned with the "other person associate with" language. I'm flagging that here for discussion at the next meeting or on this e-list.

c. "which reasonably might be imputed" vs. "reasonably imputable"

7. I removed "all" as a modifier of "confidential information" in both (B) and (C). After 6068(e)(2) and rule 3-100 become operative on July 1, 2004, I think "all" will be inaccurate.

8. Wherever "best interests of the organization" appears, I have inserted "lawful" between "best" and "interests" in keeping with current 3-600.

9. I made the same changes to (D) as I made to (C). Again, my language is inelegant and, after considering Stan's draft, perhaps no longer the view of the Commission members. I just wanted to flag the issue for discussion. I think the language can be worked out at the meeting or on the e-list.

10. I haven't done anything with the Discussion paragraphs except to number them for ease of discussion at the meeting or on the e-list.

Thanks,
Kevin

Lamport, Stanley W. wrote:

1. Attached is a discussion draft of rule 3-600 in both clean and redlined versions. I revised paragraph (B) along the lines we discussed at the last meeting and ran with the ball from there. I also took a stab at the Discussion. There is more I would like to put into the Discussion, but, inexplicably, I ran out of steam.

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Rule 3-600. Organization as Client

(A) In representing an organization, a member shall conform his or her representation to the concept that the client is the organization itself, acting through its highest authorized officer, employee, body, or constituent overseeing the particular engagement.

(B) If a member ~~acting on behalf of~~ an organization knows that an ~~actual officer, employee or apparent agent of other person associated with~~ the organization acts or intends to act or refuses to act in a manner that is or may be a violation of a legal obligation to the organization or a violation of law which reasonably ~~imputable~~ might be imputed to the organization, the member shall not violate his or her duty of protecting ~~all~~ confidential information as provided in Business and Professions Code section 6068, subdivision (e). Subject to Business and Professions Code section 6068, subdivision (e), the member may take such actions as appear to the member to be in the best lawful interest of the organization. Such actions may include among others:

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

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

(C) If a member ~~acting on behalf of~~ an organization knows that an ~~actual officer, employee or apparent agent of other person associated with~~ the organization acts or intends to act or refuses to act in a manner that is likely to result in substantial injury to the organization, whether or may be not the action or refusal to act is a violation of a legal obligation to the organization, or a violation of law which reasonably ~~imputable to the organization, and that is likely to, result in substantial injury~~ may be imputed to the organization, the member ~~may take actions permitted in paragraph (B)~~ shall proceed as is reasonably necessary in the best lawful interest of the organization. Unless the member reasonably believes that it is not necessary in the best lawful interest of the organization to do so, the member shall, subject to the member's duty to protect confidential information as provided in Business and Professions Code section 6068, subdivision (e), ~~the member shall~~ refer the matter to higher authority in the organization, including, if warranted by the seriousness of the circumstances, to the highest internal authority that can act on behalf of the organization as determined by applicable law.

(D) If, despite the member's actions in accordance with paragraph (C), the highest authority that can act on behalf of the organization insists upon action or a refusal to act that is likely to result in substantial injury to the organization, whether or not the act or refusal to act is a violation of a legal obligation to the organization, or a violation of law which reasonably ~~imputable to the organization and is likely to result in substantial injury~~ may be imputed to the organization, the member's response is limited to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700.

(E) A member who reasonably believes that he or she has been discharged because of the member's actions taken pursuant to paragraph (C)2, or who withdraws under circumstances that require or permit the member to take action under paragraph (C)2, and who has not informed the highest internal authority that can act on behalf of the organization of the circumstances, shall so inform such authority unless the member reasonably believes that it is not necessary in the best lawful interest of the organization to do so.

(F) In dealing with an organization's directors, officers, employees, members, shareholders, or other constituents, a member shall explain the identity of the member's client, when the member knows or reasonably should know that the organization's interests are adverse to those of the constituent(s) with whom the member is dealing. In such circumstances, the member shall not mislead such a constituent into believing that the constituent may communicate confidential information to the member in a way that will not be used in the organization's interest.

(G) A member representing an organization may also represent any of its directors, officers, employees, members, shareholders, or other constituents, subject to the provisions of rule 3-310. If the organization's consent to a dual representation is required by rule 3-310, the consent shall be given by an appropriate constituent of the organization other than the individual or constituent who is to be represented, or by the shareholder(s) or organization members.

Discussion:

[1] Rule 3-600 is intended to apply to all forms of legal entities including corporations, limited liability companies, partnerships, and incorporated and unincorporated associations.

[2] Rule 3-600 is intended to require members to be cognizant of their role when representing an organization and to refrain from conduct that would lead a constituent to reasonably believe that the member is representing the constituent individually, when the member does not intend to create such a relationship. At the same time, Rule 3-600 is not intended to prohibit members from representing both an organization and a constituent of an organization in the same matter, so long as the member has addressed the potential or actual conflicts of interest that may arise from such dual representation pursuant to Rule 3-310(C)(1) and (C)(2). Rule 3-600 is also not intended to prohibit members from representing both an organization and a constituent of an organization in separate matters, so long as the member has addressed the conflicts of interest that may arise. (See State Bar Formal Opn. 2003-163.)

[3] When constituents of an organization make decisions for it, ordinarily a member must accept those decisions even if their utility or prudence is doubtful. At the same time, a member has a duty to inform a client of significant developments related to the representation under Rule 3-500 and Business and Professions Code section 6068, subdivision (m). Paragraphs (B) and (C) address the application of the duty to inform a client in the context of the representation of an organization.

[4] The difference between paragraph (B) and paragraph (C) turns on whether the violation of the legal duty to the organization or the violation of law is likely to result in substantial injury to the organization. When the violation is likely to result in substantial injury to the

organization, the member must inform higher authority in the organization unless the member reasonably believes that it is not necessary in the best interest of the organization to do so.

[5] References to the best interest of the organization in Rule 3-600 are not intended to require a member to exercise judgment for the organization or to take action on behalf of the organization independently of the direction the member receives from the constituent(s) overseeing the engagement. In determining the best interests of the organization, members should consider the extent to which the organization should be informed of the circumstances and the direction the member has received from the organization client.

[6] In determining how to proceed under paragraphs (B) and (C) members should give due consideration to the seriousness of the violation and its consequences, the responsibility of the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations.

[7] In circumstances governed by paragraph (C), ordinarily, referral to a higher authority would be necessary. In some circumstances, however, it may be appropriate for the member to ask the constituent to reconsider the matter; for example, if the circumstances involve a constituent's innocent misunderstanding of the law and subsequent acceptance of the member's advice, the member may reasonably conclude that the best interest of the organization does not require the matter be referred to higher authority. If the constituent persists in conduct contrary to the member's advice, it will be necessary for the member to refer the matter to a higher authority in the organization. If the matter is of sufficient seriousness and importance or urgency to the organization, referral to higher authority in the organization may be necessary even if the member has not communicated with the constituent.

[8] Paragraph (E) is intended to address a member's duty to take reasonable steps to avoid reasonably foreseeable prejudice to the rights of the client under Rule 3-700(A)(2) when the member or the organization terminates the member's representation.

[9] Rule 3-600 is not intended to create or to validate artificial distinctions between entities and their officers, employees, or members, nor is it the purpose of the rule to deny the existence or importance of such formal distinctions. In dealing with a close corporation or small association, members commonly perform professional engagements for both the organization and its major constituents. When a change in control occurs or is threatened, members are faced with complex decisions involving personal and institutional relationships and loyalties and have frequently had difficulty in perceiving their correct duty. (See *People ex rel Deukmejian v. Brown* (1981) 29 Cal.3d 150 [172 Cal.Rptr. 478]; *Goldstein v. Lees* (1975) 46 Cal.App.3d 614 [120 Cal.Rptr. 253]; *Woods v. Superior Court* (1983) 149 Cal.App.3d 931 [197 Cal.Rptr. 185]; *In re Banks* (1978) 283 Ore. 459 [584 P.2d 284]; 1 A.L.R.4th 1105.) In resolving such multiple relationships, members must rely on case law.

Rule 3-600. Organization as Client

(A) In representing an organization, a member shall conform his or her representation to the concept that the client is the organization itself, acting through its highest authorized officer, employee, body, or constituent overseeing the particular engagement.

(B) If a member for an organization knows that an officer, employee or other person associated with the organization acts or intends to act or refuses to act in a manner that is or may be a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization, the member shall not violate his or her duty of protecting confidential information as provided in Business and Professions Code section 6068, subdivision (e). Subject to Business and Professions Code section 6068, subdivision (e), the member may take such actions as appear to the member to be in the best lawful interest of the organization. Such actions may include among others:

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(C) If a member for an organization knows that an officer, employee or other person associated with the organization acts or intends to act or refuses to act in a manner that is likely to result in substantial injury to the organization, whether or not the action or refusal to act is a violation of a legal obligation to the organization or a violation of law which reasonably may be imputed to the organization, the member shall proceed as is reasonably necessary in the best lawful interest of the organization. Unless the member reasonably believes that it is not necessary in the best lawful interest of the organization to do so, the member shall, subject to the member's duty to protect confidential information as provided in Business and Professions Code section 6068, subdivision (e), refer the matter to higher authority in the organization, including, if warranted by the seriousness of the circumstances, to the highest internal authority that can act on behalf of the organization as determined by applicable law.

(D) If, despite the member's actions in accordance with paragraph (C), the highest authority that can act on behalf of the organization insists upon action or a refusal to act that is likely to result in substantial injury to the organization, whether or not the act or refusal to act is a violation of a legal obligation to the organization or a violation of law which reasonably may be imputed to the organization, the member's response is limited to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700.

(E) A member who reasonably believes that he or she has been discharged because of the member's actions taken pursuant to paragraph (C), or who withdraws under circumstances that require or permit the member to take action under paragraph (C), and who has not informed the highest internal authority that can act on behalf of the organization of the circumstances, shall so inform such authority unless the member reasonably believes that it is not necessary in the best lawful interest of the organization to do so.

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Discussion:

[1] Rule 3-600 is intended to apply to all forms of legal entities including corporations, limited liability companies, partnerships, and incorporated and unincorporated associations.

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[4] The difference between paragraph (B) and paragraph (C) turns on whether the violation of the legal duty to the organization or the violation of law is likely to result in substantial injury to the organization. When the violation is likely to result in substantial injury to the

organization, the member must inform higher authority in the organization unless the member reasonably believes that it is not necessary in the best interest of the organization to do so.

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[8] Paragraph (E) is intended to address a member's duty to take reasonable steps to avoid reasonably foreseeable prejudice to the rights of the client under Rule 3-700(A)(2) when the member or the organization terminates the member's representation.

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extent to which the organization should be informed of the circumstances and the direction the member has received from the organization client.

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To: Lauren McCurdy
for Commission distribution

Date: May 3, 2004

Subject: Comment on Proposed Rule 3-600.

I don't quite know how it happened that I got out of the loop on the drafting, but I appreciate the opportunity to be a kibitzer rather than having to carry the load.

Much of what Jerry Sapiro says in his March 30 e-mail is soundly based. The critical element in 3-600(B) [and (C)?] is the empowerment of the lawyer to go up the ladder. And it is an empowerment, not a mandate. I have the same problems in seeing disciplinary consequences of action or inaction here that I did 20 years ago, although we are continuing the sanction type language that the lawyer "shall" etc., in 3-600(A).

Leaving aside the issue of "agent," on which I side with Kevin, we are really trying to make the following points:

- The lawyer shall be proactive in seeking to have the client prevent, perhaps correct, meliorate (etc.) any improper conduct of its personnel.
- "Improper conduct" can vary in its severity and in its consequences. Dropping a pint can of motor oil over the gunwale should not normally go all the way to the board of directors—although if attempts to deal prophylactically with such a situation disclose a dangerous, wholesale disregard of anti-pollution laws, even that little incident could trigger up-the-line concerns or rights.
- On the issue of how-far-up-the-line, I note that Rule 3-600(A) and the *Brooklyn Navy Yard* case hold that the entity is (at least for purposes such as we are talking about, I think) a closed container: shareholders may have the right to oust the board of directors, but they are not "in the loop" with respect to issues of management and conduct. California has never adopted the *Garner v. Wolfenbarger* rule.
- So seen, why do we need both (B) and (C)? Without repeating all of the language about triggering circumstances, can't we just say that where such circumstances exist, and depending upon the gravity of the situation, the lawyer may, but must not, go up the line as far as (in his or her judgment) the situation deserves? And that there may be circumstances in which the lawyer must resign?
- And confidentially and privilege must remain protected.

Seems to me that all this can be said in one paragraph, not two, so that the reader will be provided with clarity.

* * *

While on that subject of confidentiality, I trust that you will have all seen recent literature and panel discussions to the effect that prosecuting entities are increasingly making it a consideration of settlement that the accused entities must waive attorney-client privilege, particularly with respect to internal investigations. This is a highly disturbing trend, since it is the very point of such investigations of misconduct by counsel—which are entirely predicated on the concepts underlying 3-600—that management needs to know what misconduct may have taken place in the lower ranks, but that at the same time this information needs to be confidential.

One can say that corporations are only creatures of the state, which they are; and that the state has the right to control all aspects of corporate life including the right *vel non* to obtain confidential advice and communications from counsel. Perhaps corporations need to be headed in in such a fashion: they seem larger than the state in many respects. But I question whether administrative actions on pain of criminal punishment are the answer.

If they are not the answer, then we are in the position to consider a remedy. Just as Rule 1-500 was expanded in the 1989 revision to prohibit a lawyer's demanding as a condition of settlement that another attorney not prosecute certain cases, so we can consider a rule which prohibits any lawyer outside the client's organizational structure from demanding or requesting a waiver of attorney-client privilege as a condition of settlement, avoidance of criminal prosecution, or indeed of anything.

I think that the prosecutorial demands of waiver of privilege are a very serious matter, an issue which by the way can easily be expanded into the general criminal law, where "up-the-ladder" prosecution, witness turning and turning on your bosses is a daily staple of prosecutorial strategy. but in the end that is a different issue than coerced privilege waiver. I think this subject should be given serious consideration.

* * *

We are of course by indirection disagreeing with the SEC regulations under SOX 307, which require going outside the organization in certain circumstances. Other elements of the State Bar have gone public with that disagreement. I have little doubt that in the end the Supremacy Clause of the Constitution will cause the SEC to prevail over Washington's and California's attempts to stem the tide; but should we refer (without taking sides) to the issue in the Discussion?

* * *

Those of you who have read Jerry Sapiro's magnificent 91 page opus on regulation, confidentiality, etc. will appreciate that the ABA has fallen (fallen back!) into the hands of largely academic elements which have revived and expanded the Kutak rules, which had been rejected in 1983. This is one of many reasons why I think the ABA rules are not a hallmark, and

that we should continue to take a principled stand for what we think is right (and for what we think is clearer and better written), just as we did in the 1980s. But I think that this train has sailed without me.

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I have a number of minor suggestions about the content of the discussion, essentially aimed at emphasizing the sound exercise of the attorney's discretion. I can take those up orally.

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Finally, a technical point with respect to present subsection (E). I have encountered situations in closely held organizations where, as in *Forrest v. Baeza* (1997) 58 Cal.App.4th 65, there are only two or three players in the organization, at odds with each other. If the person not in control sues both the organization and the other party or parties, there is no disinterested party to give consent to the dual representation of all defendants. I think that we should provide that where all are interested, the control group can retain one counsel both for it and for the entity unless overriding reason to the contrary appears. In fact, I have taken that position as an expert in at least one court filing.