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PROFESSIONAL RESPONSIBILITY

# Advising startups: Who's the client?

By William K. Mills

"2 dudes walk into a law office...' That line sounds like the start of a very bad joke, but unless the lawyer who assists them takes a steady and disciplined approach, he won't be the one laughing in the end.

In this scenario, the two dudes, Mr. Smith and Mr. Jones, who will be referred to as "Founders," want to start a business. However, they have no idea what they are doing or where to start. They consult with Mr. Brown, a longstanding member of the California Bar, who without preparing an engagement agreement advises them that a "fast and dirty" California limited liability company will suit their needs. Mr. Brown sets up "Talking Frog LLC." Mr. Smith pays personally for Mr. Brown's time and advice.

Sometime later, Mr. Smith returns to Mr. Brown with questions. He has concerns about the fact that he has the technology and contributed the start-up money, while Mr. Jones only contributes his time to the business. Mr. Brown indicates that Mr. Smith may need additional documents to reflect their distinct and unequal positions. Mr. Brown drafts several documents, including nondisclosure agreements and an amendment to the LLC operating agreement. He also gives personal advice to Mr. Smith. Mr. Jones also periodically consults Mr. Brown concerning various issues at Talking Frog LLC.

Later still, Talking Frog LLC grows and becomes commercially successful. However, after several years a dispute arises concerning the ownership of certain company assets. Mr. Jones contacts Mr. Brown and requests that he represent him in his claims against Mr. Smith and Talking Frog LLC.

A light bulb finally goes off when Mr. Brown recognizes for the first time that he may be facing serious ethical issues. He wonders whether he should seek the advice of an attorney with legal ethics expertise. He finally reaches out to attorney White Knight, to whom Mr. Brown tells his tale. Mr. Knight, who regularly consults with attorneys on how to avoid conflicts of interest and malpractice by proactively anticipating and resolving such issues, gives Mr. Brown the short course on the subject.

Mr. Knight explains that the circumstances in which Mr. Brown finds himself are frequently repeated in one form or another among California lawyers. Often a lawyer too quickly or casually approaches his business relationship with new clients, leaving loose ends that cause later missteps or worse subjects the lawyer to malpractice claims or discipline.

He goes on to affirm that a thoughtful and organized approach with every new client can help avoid later problems. Moreover, Mr. Knight explains that while ethics experts can certainly use the work, doing things the right way may make those consultations less necessary or financially painful.

The message Mr. Knight conveyed to Mr. Brown is simple: start the relationship off correctly with a written engagement agreement. *Do so with each new engagement*, even though it's not absolutely required in every engagement (see Business and Professions Code Section 6148).

Every lawyer is governed by the California Rules of Professional Conduct (CRPC) and legal decisions which define the "standard of practice" as finite boundaries or "zones" within which lawyers practice. However, understanding the interplay between the laws governing conduct and ethics and the practical aspects of real-world decisions confronting lawyers is critical.

When approaching the representation of new businesses of any category, one of the first questions confronting lawyers is "Who is the client?" It is that question which precedes the selection by the new business organizers of the type of business entity they intend to start. Identification of the client is determined by the lawyer. In this case, Mr. Brown, not chance or his clients, should have made that election before providing any advice and in the context of preparing a written fee agreement, which is always advisable and recommended, whether he would be representing Mr. Smith, Mr. Jones, the prospective entity, or some combination.

Mr. Knight and other ethics experts agree that in a start-up scenario, the new entity should always be the client, unless some specific reason exists to represent one or both of the Founders. (For example, there are occasions in which a lawyer may be retained specifically to represent the individual founders and another lawyer or firm to represent the new entity in order to avoid actual or potential conflicts that have already been identified.) Moreover, should a lawyer represent individuals in the start-up process, it is advisable and recommended that each clients' written informed consent be obtained before the engagement is commenced to assure proper disclosures are made consistent with the lawyer's obligations under CRCP 3-310.

Often little consideration is given to the identity of the client before the lawyer sets to the task of forming the entity. However, any lawyer who does not recognize the significance of answering that issue early in the attorney-client relationship misses an opportunity to resolve issues that span the life of the engagement from the execution of an engagement agreement to identifying the client goals and objectives, to maintaining the relationship by properly managing those goals and objectives through an amicable and successful termination.

Common issues that should be resolved in identifying the client include whether the client or a third party has financial responsibility, or whether the client is or will designate the decision-maker. If the clients are husband and wife or partners, like Mr. Smith and Mr. Jones, some consideration should be given to how decisions are made, who has authority and how disputes are resolved, and something often overlooked, at termination, who gets custody of the original file under CRPC 3-700(D).

Also, issues of joint and concurrent representations implicate attorney-client privilege issues (see Cal. Evid. Code Sections 958 and 952), which commonly require written disclosure or consent, that must be identified and properly resolved.

The failure to identify the client opens the door to serious problems later in the attorney-client relationship. This is true especially where disputes arise among organizers or investors and the lawyer later struggles directly from the confusion caused by the failure initially to have focused on the identity of the client.

When Mr. Brown asks Mr. Knight the question, "Can I represent Mr. Jones against Mr. Smith or Talking Frog LLC?," if Mr. Brown has properly identified the client in the first instance, he would get an easier answer. That answer could be "Yes" or "No," but could depend on whether Mr. Brown obtained advance consent to continue representing one of the Founders or Talking Frog LLC in the event of a dispute between them. The written retainer agreement would have the perfect opportunity to clarify that relationship. (However, under no circumstance would Mr. Brown be permitted to use one client's confidential information obtained during the joint representation against that client. See CRCP 3-310(E).)

If Mr. Brown has not propertly identified the client, then Mr. Knight would advise Mr. Brown that he may have to decline to represent Mr. Jones, give him advice, or otherwise withdraw from involvement in disputes between or among Mr. Jones, Mr. Smith or Talking Frog LLC. See CRCP 3-310; *Havasu Lakeshore Investments, LLC v. Fleming*, 217 Cal. App. 4th 770, 778 (2013).

Because of the lack of clarity, Mr. Knight's response to Mr. Brown's question could be quite complicated, as it will necessarily require an analysis of the relationship between the issues in dispute and Mr. Brown's prior representation of Mr. Jones or Talking Frog LLC, and most importantly, whether either will argue that Mr. Brown received confidential information, which would be presumed. See *Faughn v. Perez*, 145 Cal. App. 4th 592 (2005).

Thus, Mr. Brown may be facing the completely predictable consequences of his failure to properly identify his client in the first instance, among which are disqualification, withdrawal, loss of the client relationship, malpractice liability, and potential discipline.

In either case, Mr. Knight's quick advice to Mr. Brown should have been to advise Mr. Jones to find other counsel. Fortunately, after consulting Mr. Knight, Mr. Brown now knows that best practices require that a lawyer representing start ups determine at the outset the identity of his client. Once the client is identified, the lawyer is able to take the next steps in documenting the attorney-client relationship including to determine the necessity, nature and content of any disclosures or consents required by CRPC 3-300 (deals with clients) or 3-310 (interests adverse to clients), and 3-600 (organizations as clients).

In our story, Mr. Brown may have learned the hard way that identification of the client in a written fee agreement can avoid risks and expenses. Especially where multiple clients are involved, particularly if principals of organization clients, the agreement must be clear and consistent throughout.

With Mr. Knight's sage advice, the next time two dudes walk into his office seeking help to start a new business, Mr. Brown will be better armed and rather than being the brunt of a bad joke, he will already know the punch line and enjoy a good laugh!

**William K. Mills**, *a partner in the Los Angeles law firm of Parker Shumaker Mills LLP, is a member of The State Bar Standing Committee on Professional Rules and Conduct (COPRAC) and a Certified Specialist, Legal Malpractice, by The State Bar of California Board of Legal Specialization.*

WILLIAM K. MILLS
*Parker Shumaker Mills*