Ethical Issues in Entity Formation and Operation

HAZENLAWGROUP.COM

717-540-4332

HAZEN LAW GROUP

PLAN TODAY. SECURE TOMORROW.

DISCLAIMER

This presentation is for educational purposes only. It is not intended as legal advice. Individual situations must be evaluated thoroughly before providing legal advice.

Scenario Overview: "The Green Pastures Farm Case"

Green Pastures Farm is a family-owned agricultural business in Adams County operating as a partnership and filing a Form 1065 with the IRS. Originally established by siblings Pat and Taylor, the farm grows produce, offers seasonal agritourism activities (such as apple picking and hayrides), and sells farm-to-table goods at local markets. As the business grows, legal and ethical issues emerge for Attorney Alex, who represents the farm at various stages.

Initial Consultation — Who is the Client?

Alex and Pat, went to high school together and are familiar with one another since their kids play Little League together. Pat approaches Alex, seeking help forming a legal entity to formalize the operation and ownership of Green Pastures Farm. Pat discloses plans, assets, family arrangements, and upcoming lease negotiations. Taylor isn’t yet involved in the conversation.

Rule 1.18 – Duties to Prospective Client

A person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client.

Even when no client-lawyer relationship ensues, a lawyer who has learned information from a prospective client shall not use or reveal information which may be significantly harmful to that person, except as Rule 1.9 would permit with respect to information of a former client.

A lawyer subject to paragraph (b) shall not represent a client with interests materially adverse to those of a prospective client in the same or a substantially related matter if the lawyer learned information from the prospective client that could be significantly harmful to that person in the matter, except as provided in paragraph (d). If a lawyer is disqualified from representation under this paragraph, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter, except as provided in paragraph (d).

When a lawyer has learned information as defined in paragraph (c), representation is permissible if:

- both the affected client and the prospective client have given informed consent; or,
- all of the following apply:
  - the disqualified lawyer took reasonable measures to avoid exposure to more disqualifying information than was reasonably necessary to determine whether to represent the prospective client;
  - the disqualified lawyer is screened from any participation in the matter and is apportioned no part of the fee therefrom; and
  - written notice is promptly given to the prospective client.

Discussion Points:

Rule 1.18 – Duties to Prospective Client
Pat may become a client, but Alex must still protect the confidentiality of the disclosures, even if Pat doesn't retain Alex.

Comment [2]: Confidential info learned in the consultation must be protected if representation doesn't proceed.

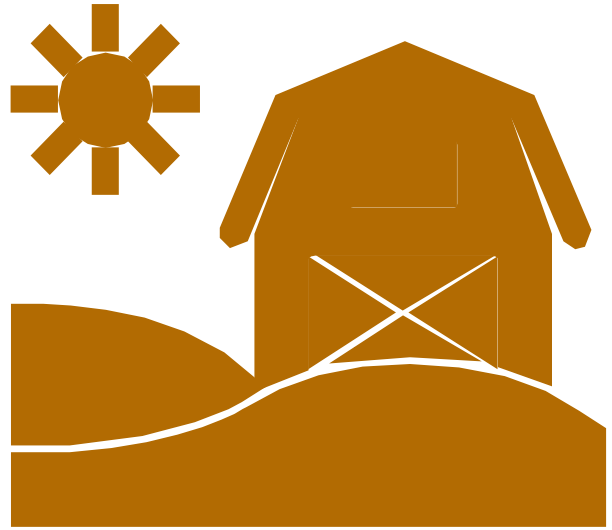
Potential conflicts if Taylor later comes to Alex as a separate client.

Roundtable Questions:

1. How should Alex clarify the scope of representation at this early stage?
2. What documents or disclaimers are advisable before hearing confidential business information?
3. What office policies do you have in place to safeguard prospective client information? To ensure that future clients are not adverse to the potential client?

Competence & Entity Formation

Although Alex's typical practice involves estate planning, estate settlement, residential real estate transactions and some general family law matters, Alex agrees to form the LLC but lacks direct experience to advise on an area of the business which is critical to Green Pastures' viability – H-2A workers who annually assist with the apple harvest. Alex files basic documents but omits key provisions in the operating agreement related to succession and equipment ownership dealing with buy-sell terms in the event of death, disability and early withdrawal and retirement.



Rule 1.1 – Competence

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

- **Discussion Point:**
- Alex may lack the legal experience to properly advise on the H-2A temporary worker issue and the succession issues. **What are the options to ensure competent advice?**
  - Comment 2: Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

Roundtable Questions:

- What are the risks to Pat and Taylor if the formation documents are incomplete or do not adequately address issues that may become major in the future? E.g. buy/sell provisions in the event of an unpleasant dispute?
- When or should Alex refer the matter to co-counsel as opposed to learning more about the issue themselves?
- Should Alex agree to represent the client in this matter or should Alex refer to a colleague who practices more frequently with business planning and formation?

Aging Clients and Capacity Questions

Pat and Taylor come to Alex and advise that their Uncle Bart, who is also Alex's client, wants to sell them a 27-acre tract of land that neighbors Green Pastures under some highly favorable terms as it pertains to Pat and Taylor's interests. When Uncle Bart comes to the office along with his wife, Aunt Bess, to sign the Agreement of Sale, Bess pulls you to the side to mention updating their estate plan because, while not formally diagnosed, Uncle Bart has been showing early signs of memory loss and had to be reminded several times today why he was coming to Alex's office.

Rule 1.14 - Client with Diminished Capacity

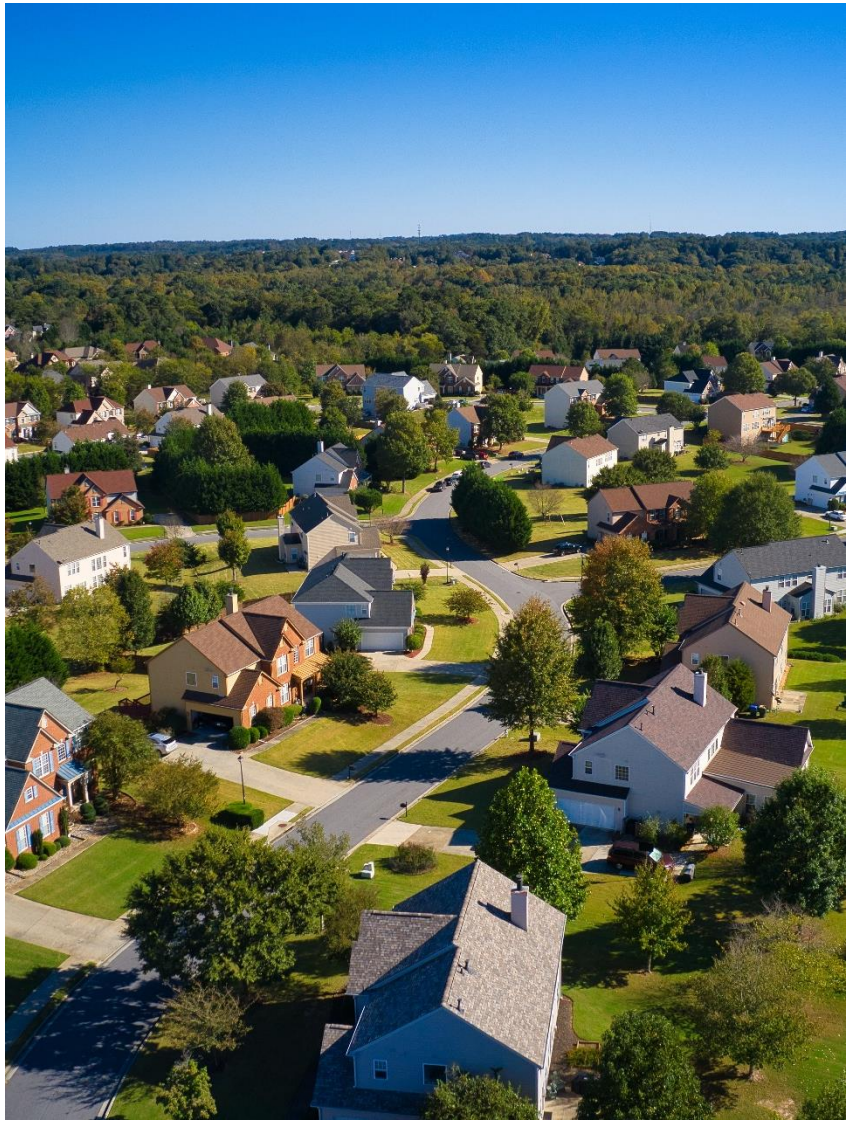
(a) When a client's capacity to make adequately considered decisions in connection with a representation is diminished, whether because of minority, mental impairment or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.

(b) When the lawyer reasonably believes that the client has diminished capacity, is at risk of substantial physical, financial or other harm unless action is taken and cannot adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client and, in appropriate cases, seeking the appointment of a guardian ad litem, conservator or guardian.

(c) Information relating to the representation of a client with diminished capacity is protected by Rule 1.6. When taking protective action pursuant to paragraph (b), the lawyer is impliedly authorized under Rule 1.6(a) to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests.

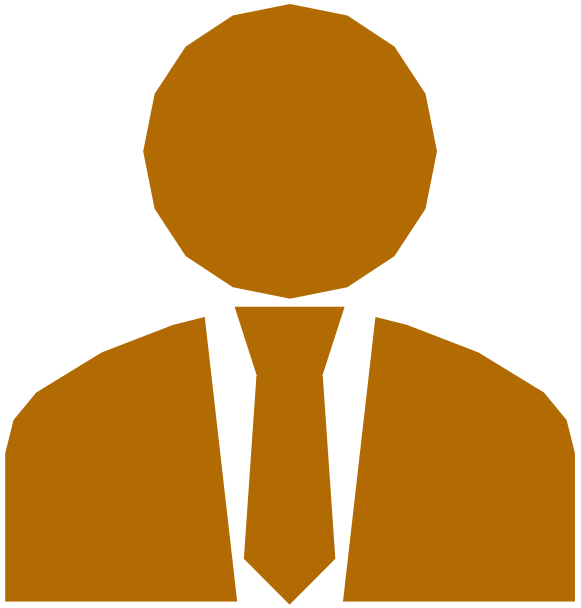
Roundtable Questions:

- Should Alex represent Uncle Bart or should there be separate representation for the parties here?
  - If Alex does represent Uncle Bart, what sort of conflict waiver would be sufficient?
- What steps can Alex take to maintain the normal attorney/client relationship?
- What additional steps, if any, might Alex take to ensure Uncle Bart understands the document he is signing?
- Would Alex's decisions change if Aunt Bess were not part of the discussion? What if this transaction involved an unrelated party?
  - Would Alex's analysis change if Uncle Bart and Aunt Bess had children? How about if the sale was occurring in connection with a diagnosis in which there is a reasonable expectation that long-term care might be needed?



Representing an Organization & Conflicts with Owners Arise

Alex continues advising the farm, involving both siblings and things run smoothly for a number of years. Operations expand and the operation is profitable. However, disputes arise over financial control and sale of part of the land to developers. Alex receives conflicting instructions from each sibling.



Rule 1.13 – Organization as Client

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

…

(d) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(e) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Discussion Points:

Rule 1.13 – Organization as Client.

The entity, not the individuals, is the client.

Comment [1]–[4]: In family-run businesses, loyalties can blur.

Alex must clarify representation to avoid confusion. If Taylor and Pat are in conflict, Alex may need to advise them to seek independent counsel under Rule 1.7 (Conflict of Interest).

Rule 1.7

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

- (1) the representation of one client will be directly adverse to another client; or,
- (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Roundtable Questions:

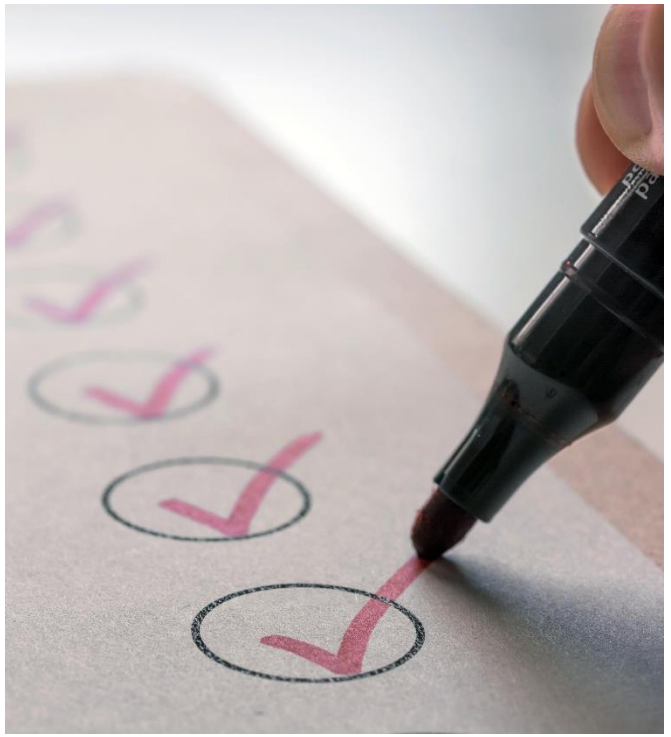
- How does Alex ethically handle disputes between members of the family farm LLC?
- What if one sibling claims to “own” the client relationship by reason of holding the majority voting share?
  - What if this is a scenario where the Operating Agreement that Alex drafted gives too much power to the manager of the LLC which has now led to these issues?
- Can Alex continue to represent the business? What if Alex now has information that is materially adverse to either Pat or Taylor?

Entity Buy-Out – Exit of Co-Founder

Things have gone south. Taylor wants to leave Green Pastures Farm and sell the ownership interest Taylor has to Pat. This buy-out will have to include the valuation of the business and the underlying assets to determine the buy-out price. But, the Operating Agreement does not provide for a valuation formula to be used in this scenario. Also involved is the tract of land that Pat and Taylor purchased at a steep discount from Uncle Bart subject to their deferred payment mortgage that is junior in priority to a mortgage with Farm Bank taken out to build a pole barn that Green Pastures Farm constructed to expand the agritourism activities on the farm. Pat wants Alex to handle the buy-out and draft the agreement, but the two cannot agree on valuation and Pat is threatening to default on the loan to Uncle if they cannot come to an agreement within 45 days. Taylor also asks Alex for guidance.

Layers of Conflicts & Confidences

- Rule 1.7 – Concurrent Conflict implicated here by Alex's obligation to Uncle?
- Rule 1.13 – Representation of Entity – also implicated by constituent's disagreement. Default would be harmful to Green Pastures and to Uncle.
- Rule 1.6 – Confidentiality. Does this fall within one of the exceptions to disclosure?



Roundtable Questions:

- Can Alex ethically represent both sides in the buy-out?
- What if Alex represented both siblings? Is it too late to "unwind" shared confidences?
- What is Alex's duty to Uncle? Is there one?

HAZEN LAW GROUP

PLAN TODAY. SECURE TOMORROW.

Gary J. Heim, Esquire
Sarah E. Straub, Esquire
Hazen Law Group LLC
2000 Linglestown Road, Suite 202
Harrisburg, PA 17110
hazenlawgroup.com
717-540-4332