

**DELAWARE STATE BAR ASSOCIATION
COMMITTEE ON PROFESSIONAL ETHICS
OPINION 1987-**

A Delaware attorney ("inquiring attorney") requests this Committee's opinion on the following questions:

QUESTIONS PRESENTED

1. Whether it is permissible under the Rules of Professional Conduct for the inquiring attorney to represent any or all of the defendants in certain pending litigation.

2. Whether it is otherwise appropriate for an associate or any other attorney in the inquiring attorney's law firm to represent a third party defendant in the litigation.

3. Whether it is appropriate for any member of the inquiring attorney's law firm to represent any of the defendants or parties in this litigation.

FACTS

The facts as submitted by the inquiring attorney are lengthy and are set out, in numbered paragraphs 1 - 30 as Exhibit A to this opinion. The following is a summary:

In 1974, Corporation D (Defendant No. 1) purchased all of the assets of, and assumed certain liabilities of, Corporations A, B, and C, the stock of which is owned by plaintiffs (individuals). Defendant No. 2 is a Delaware general partnership whose partners are defendant No. 3 (an attorney in inquiring attorney's law firm) and Defendant No. 4, an individual.

Corporations A, B, and C agreed in 1974 to indemnify the purchaser (Corporation D) and Defendants No. 3 and No. 4 individually guaranteed the bond. Corporation A subsequently assigned the Bond to plaintiffs.

Defendants have not all made payments pursuant to the bond, asserting that Corporation D in 1974 misrepresented the value of its assets. Defendants sold the assets to a Third Party, which sale occurred prior to the filing of the Complaint. In that transaction, defendant No. 3 represented himself, Defendant No. 2, and Defendant No. 4. Third Party was represented by another member of inquiring attorney's firm. Plaintiffs now have brought a civil action against defendants 1-4. Third Party has not yet been formally joined in the litigation.

Third Party claims that Defendants No. 3 and No. 4 are liable in indemnification to Third Party. Defendant No. 3 wishes inquiring attorney to represent him in the litigation. Third Party wishes representation by another member of inquiring attorney's law firm.

Third Party may also have a claim against a local bank. Defendants Nos. 2, 3, and 4 do not want the local bank joined as a party to the action.

OPINION OF COMMITTEE

The Delaware Lawyers' Rules of Professional Conduct prohibit representation by the inquiring attorney of the individual defendant No. 3 (attorney in law firm), any other defendant, and the third party. In short, the Committee believes that all attorneys in the inquiring attorney's law firm are disqualified from representing any of the defendants and the third party.

DISCUSSION

Rule of Professional Conduct 1.7 provides as follows:

"Rule 1.7 Conflict of Interest: General Rule

(a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

- (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
- (2) each client consents after consultation.

(b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:

- (1) the lawyer reasonably believes the representation will not be adversely affected; and
- (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved."

There seems little question that the interests of defendants 1 through 4, and Third Party, are adverse to each other. Among other potential issues, Third Party believes defendants 3 and 4 are liable in indemnification to him (denied by defendants 3 and 4), and third party apparently wishes a claim brought against local bank whereas defendants 2, 3, and 4 resist that position. Even though the present clients of the firm (defendants 1 through 4) consent to the inquiring attorney's representation of them against Third Party (who, in turn, is now represented by another associate in the firm), the Committee believes that the representation is directly adverse and, even though each client has purported to consent after consultation, the Committee nevertheless believes that no attorney in the firm can "reasonably [believe]" that the representation of either defendants 1 through 4 or Third Party would not adversely affect the relationship with other clients in the litigation. This particular factual situation appears to be the kind of case where a lawyer should not even ask for consent since the adverse positions appear so significant:

"... a strong presumption against simultaneous representation of clients with directing conflicting interests is warranted precisely because these are the cases that most clearly involve the two main dangers which Rule 1.7 as a whole is designed to avoid, namely

that confidential information will "leak" from one camp to the other and that clients and the public at large will be disturbed by the sight of one lawyer [or one law firm] disloyally 'playing both sides of the street', earning two fees and possibly pulling his punches ..."

"The strong presumption against simultaneous representation of clients with directly conflicting interests also operates as a limitation on the client consent provision of Rule 1.7(a)(2). In cases where one of the clients is an individual, as opposed to a business or other entity, the client's personal feelings will almost necessarily be bound up in any legal transaction to which he is a party and the risk of impairing the client-lawyer relationship will therefore be high. Since a lawyer involved in such a case normally will not be reasonably able to entertain a belief that none of the client-lawyer relationships will be adversely affected, he may not even ask for consent. Rule 1.7(a)(1) would bar the representation even if consents were obtained from each of the clients ... "

Geoffrey C. Hazard, Jr., and W. William Hodes, The Law of Lawyering: A Handbook on the Modal Rules of Professional Conduct (1986 edition), p. 133.

Therefore, neither Third Party or Defendants 1-4 should be represented by the firm. Even though Third Party consented to representation by the law firm in the transaction, and purports to consent to continued representation, nevertheless the degree of involvement by inquiring attorney and attorney for Third Party makes impermissible the continued representation of any parties in the litigation.

The Committee is also concerned that, under the facts submitted, defendant No. 3, the individual attorney in the inquiring attorney's law firm, might be called as a witness as to a contested issue. Rule 3.7 provides as follows:

"Rule 3.7 Lawyer as Witness

(a) A lawyer shall not act as advocate at a trial in which the lawyer is likely to be a necessary witness except where:

- (1) the testimony relates to an uncontested issue;
- (2) the testimony relates to the nature and value of legal services rendered in the case; or
- (3) disqualification of the lawyer would work substantial hardship on the client.

(b) A lawyer may act as advocate in a trial in which another lawyer in the lawyer's firm is likely to be called as a witness unless precluded from doing so by Rule 1.7 or Rule 1.9."

The facts suggest that defendant No. 3 may be called to testify as to a contested issue (the indemnification issue), and the Committee cannot conclude from the facts that disqualification of the inquiring attorney's law firm to represent any of the defendants or third party would work "substantial hardship" on either the individual defendants or third party.

The Committee cannot conclude from the facts presented that it was necessarily a violation of Rule 1.8, "Conflict of Interest: Prohibited Transactions", for defendant No. 3, an individual attorney in an inquiring attorney's law firm to have entered into the business transaction with a client. Nevertheless, that fact has caused defendant No. 3 to have become enmeshed in the subsequent litigation which would prevent any other member of his firm from representing any of the parties whose positions are now antagonistic to each other.

The Committee's view is not changed by the fact that Third Party waived any potential conflict in connection with its being represented by another member of inquiring attorney's law firm. Indeed, Third Party continues to request another member of inquiring attorney's law firm to represent Third Party. However, for the reasons stated above, such consent is impermissible under the rules and inquiring attorney's law firm should decline to represent Third Party. See Rule 1.10 ("Imputed Disqualification: General Rule"), prohibiting one lawyer from representing a client when anyone of them otherwise individually and practicing alone would have been prohibited from representing same.

CONCLUSION

It is inappropriate and a violation of the Rules of Professional Conduct for inquiring attorney or any other attorney in inquiring attorney's law firm to represent any of the defendants or Third Party in ^{the} pending litigation.

(1) In 1974 an agreement was entered into whereby Corporation D agreed to purchase all of the assets of Corporations A, B, and C and to assume certain liabilities of Corporations A, B, and C, said liabilities being reduced to writing and attached as a Schedule to the Agreement For The Purchase Of Assets.

(2) Corporations A, B, and C were engaged in the business of the sale of mobile homes.

(3) All of the issued stock of Corporations A, B, and C was, and, to the best of my knowledge, continues to be owned by the Plaintiffs; the Plaintiffs are individuals.

(4) All of the issued stock of Corporation D was at the time of the Agreement and for some time thereafter, owned by Defendants No. 3 and 4.

(5) Corporation D is a Defendant in the current action and shall also be described herein as Defendant No. 1.

(6) Defendant No. 2 is a Delaware general partnership and the partners therein are Defendants 3 and 4.

(7) Defendant No. 3 is an individual and is an attorney in my firm.

(8) Defendant No. 4 is an individual.

(9) The Agreement For The Purchase Of Assets of Corporations A, B, and C stated that the purchase price for said assets was in the approximate amount of \$193,000.00 and required that a bond in said amount be given to Corporation A at settlement.

(10) The Agreement For The Purchase Of The Assets of Corporations A, B, and C included an indemnification clause whereby Corporations A, B, and C agreed to indemnify the purchaser with regard to any loss, cost, expenses, or damages incurred by the purchaser with respect to (i) any and all liabilities, accrued or unaccrued, absolute or contingent, existing as of the date of final settlement not otherwise provided for in the Agreement; (ii) any claims, debts, demands or causes of actions made against the property being sold, accrued or unaccrued, absolute or contingent, existing prior to the date of or on the date of final settlement, including the cost of defending same not otherwise provided for in the agreement; (iii) any and all damages resulting from any misrepresentations, breach of warranty, failure to perform any covenant or agreement contained in the Agreement, or breach of any warranty or representation made in the Agreement; and (iv) any and all actions, suits, proceedings, claims, demands, judgements, costs and expenses incident to any of the foregoing. Additionally, the Agreement expressly provided that the indemnification provision shall survive settlement.

(11) The Agreement For The Purchase Of Assets of Corporations A, B, and C was guaranteed individually by the Plaintiffs and was guaranteed individually by Defendants 3 and 4.

(12) On the day of settlement a bond was made and given by Defendant 1 (Corporation D) and by Defendant 2 to Corporation A in the approximate amount of \$193,000. Said bond was personally guaranteed by Defendants 3 and 4.

(13) Thereafter, Corporation A assigned the bond to the Plaintiffs.

(14) On the date of settlement an agreement entitled Set-Off Agreement was entered into between Corporation A and Corporation D wherein Corporation A, jointly and separately with its guarantors, the Plaintiffs, agreed to indemnify Corporation D in respect to any loss, cost, expense (including, without limitation, reasonable attorney's fees), or damage suffered by Corporation D resulting from, arising out of or incurred with respect to (a) any and all liabilities, accrued or unaccrued, absolute or contingent, existing as of the date of the Set-Off Agreement not otherwise assumed by Corporation D by virtue of the Agreement For Purchase Of Assets of Corporations A, B, and C; (b) any claims, debts, demands or causes of action made against the property being sold, accrued or unaccrued, assumed by Corporation D by virtue of the agreement to purchase the assets of Corporations A, B, and C; (c) any and all damages resulting from misrepresentation, breach of warranty, failure to perform any covenant or agreement contained in the Agreement For The Purchase Of Assets or any other document executed by Corporation A; and (d) any and all actions, suits, proceedings, claims, demands, judgements, costs and expenses incident to any of the foregoing. Additionally, Corporation A and its guarantors, the Plaintiffs, agreed in the Set-Off Agreement that in the event that Corporation D makes any payments to creditors, suppliers, taxing authorities, or other persons making a claim to Corporation D which creditors, suppliers, taxing authorities, or other persons are not listed in the Agreement For Purchase Of Assets or are owed in excess of the amounts stated in the Agreement For Purchase Of Assets, Corporation D may, at its discretion and without prior notice to Corporation A, set-off said payments against amounts (either principal or interest) owed to Corporation A by Corporation D pursuant to the bond in the approximate amount of \$193,000.00. In addition thereto, Corporation D may make such payments as it, in its sole discretion, deems proper to pay for repairs to homes sold by Corporation A to purchasers of said homes. Any payments made by Corporation D may be set off against amounts (either principal or interest) owed to Corporation A.

(15) The Set-Off Agreement was individually guaranteed by the Plaintiffs.

(16) Subsequent to settlement, payments were made upon the Bond by Defendant 2 to the Plaintiffs and various set-offs were acknowledged by the Defendants and the Plaintiffs whereby the principal amount due pursuant to the Bond as of December of 1985 was approximately \$145,000.00. Subsequent to December of 1985 no further payments were made upon the Bond by any of the Defendants.

(17) The Defendants allege that payments have not been made on the Bond since December of 1985 pursuant to the indemnification agreements in the Agreement For Purchase Of Assets and in the Set-Off Agreement and due to the Defendants right of set-off as contained in the Set-Off Agreement based upon misrepresentations that were made prior to, at and subsequent to settlement by the Plaintiffs and by Corporation A as to the true value of the assets purchased by Corporation D and as to the existence, nature and amount of liabilities of Corporations A, B, and C, both real and contingent, existing as of the date of settlement.

(18) Thereafter the Plaintiffs brought a civil action as against the four previously identified Defendants upon the Bond in the amount of approximately \$145,000 together with interest hereon.

(19) Subsequent to December of 1985 and prior to the filing of the above referenced civil action, Defendants 3 and 4 sold all issued stock and the assets of Corporation D (Defendant 1) to a third party (hereinafter "Third Party") who is not a party to the Plaintiff's action.

(20) At the settlement regarding the sale of the stock and assets of Corporation D, Defendants 3 and 4 (the sellers in that transaction) were represented either by Defendant 3 or by this firm. Third Party was represented by another member of this firm and was advised as to any possible or any perceived conflict arising out of said representation and being so advised he elected to continue to be represented by said member of this firm (for point of clarification, the undersigned was not the attorney in this firm who represented Third Party).

(21) Third Party asserts that representations were made prior to, at, and subsequent to settlement that Third Party and Corporation D were to be indemnified by Defendants 3 and 4

regarding any and all claims arising out of the Bond to Corporation A as assigned to the Plaintiffs, however the settlement documents do not contain language of indemnification whereby Third Party is indemnified by Defendants 3 and 4 with regard to the Bond to Corporation A although language is contained in said documents exempting the Bond to Corporation A from the liabilities of Corporation D which are assumed by Third Party in said settlement documents. Additionally, the language in the settlement documents does not exempt Corporation D from liability arising out of the Bond to Corporation A and said documents do not indemnify Corporation D (Defendant 1) as against claims arising out of the Bond to Corporation A.

(22) At Third Party's insistence, Third Party continues to be represented by the member of this firm who represented Third Party at the settlement wherein Third Party purchased the stock and assets (and assumed certain liabilities) of Corporation D.

(23) It is anticipated that Third Party will assert its claim for indemnification for Third Party and for Corporation D (Defendant 1) as against Defendants 3 and 4 based upon representations made to Third Party by Defendants 3 and 4 although apparently, inadvertently deleted from the settlement documents.

(24) Defendant 3 has requested that I represent Defendants 2, 3 and 4 with regard to the action brought by the Plaintiffs on the Bond. Third Party continues to request that its attorney (the attorney in this firm who represented Third Party at settlement) represent Third Party and Corporation D (Defendant 1) in this action.

(25) I have prepared and filed an Answer to the Plaintiff's Complaint signed by myself and Third Party's attorney wherein affirmative defenses have been raised based upon the misrepresentations of Corporation A and the Plaintiffs with regard to the true value of the assets purchased and with regard to misrepresentations made by Corporation A and the Plaintiffs with regard to the existence, nature and extent of liabilities of Corporations A, B, and C as of the date of settlement in 1984. Additionally, the Answer sets forth by the Counterclaim the Defendant's right to set-off and to indemnification as against the Plaintiff's by virtue of the Set-Off Agreement and other provisions of indemnity previously discussed and demands judgement as against the Plaintiff's to the extent that said set-offs exceed the amount demanded in Plaintiff's Complaint. The Answer does not assert any claims by Corporation D (Defendant 1) as against any of the other Defendants, nor does the Answer seek indemnification as against any of the

Defendants on behalf of Third Party. Additionally, the Answer does not seek to assert any claims against a local bank (hereinafter "Local Bank") on behalf of any of the Defendants nor on behalf of Third Party for claims arising out of the transaction discussed in the following paragraphs.

(26) Perhaps one of the most significant rights of set-off as against the Plaintiff's claim asserted by the Defendants in their Answer involves a Dealer's Reserve Account with Local Bank which was maintained by Corporations A, B, and C with regard to the floor planning of their mobile home inventory. This Dealer's Reserve Account was established by Local Bank for the purpose of providing unto the dealer a portion of the interest earned upon each customer contract and for the purpose of covering certain losses incurred in the course of said mobile home business, most notably from defaults upon customer's security agreements. Pursuant to Local Bank's policy and pursuant to the Recourse Agreement assumed by the Defendants in conjunction with the purchase of assets of Corporations A, B, and C, the Dealer's Reserve Account must not fall below 3% of all outstanding liabilities pursuant to the floor planning agreement with Local Bank. Sometime prior to the 1984 purchase of assets, Local Bank permitted someone (the identity of whom is not yet known to me or to Defendants) to withdraw sums of money from the Dealer's Reserve Account whereby the Dealer's Reserve Account balance fell appreciably below the required 3% level. The Plaintiffs failed to disclose this fact at the 1984 settlement, the net effect being that, by virtue of the assumption of the Recourse Agreement with regard to the Dealer's Reserve Account, the Defendants stand actually and potentially liable for all amounts duly chargeable against the Dealer's Reserve Account due to defaults by customers of Corporation A, B, and C, a contingent liability which may exceed the amount claimed by the Plaintiffs and their action.

(27) When Third Party purchased the assets of Corporation D Third Party assumed the Recourse Agreement of Corporation D with Local Bank. Additionally, Third Party and Third Party's wife have personally guaranteed same.

(28) Third Party believes that Third Party or Corporation D (Defendant 1) may have a claim against the Local Bank with regard to Local Bank's permitting the unauthorized withdrawal of funds from the Dealer's Reserve Account.

(29) The Dealer's Reserve Account balance dropped to 0 in November of 1986 and Local Bank has taken the position that Third Party and Corporation D are liable for monthly defaults by consumer debtors. Third Party wishes to settle with Local Bank whereby Local Bank is to either deposit sufficient sums into the Dealer's Reserve Account so as to cover monthly

defaults or to release Third Party and Corporation D from the Recourse Agreement and forgive current defaults and, whereby Local Bank will place all of Corporation D's inventory on floor planning as was initially promised by Local Bank. It is not known, however whether Local Bank will consent to these terms without the initiation of litigation against Local Bank. In the event that Local Bank brings the Dealer's Reserve Account up to the appropriate level or releases Third Party and Corporation D from the recourse agreement and forgives current defaults, a significant portion of Defendants' Counterclaim as against Plaintiffs will be defeated.

(30) Defendants 2, 3 and 4 have expressed a desire that Local Bank not be joined by Defendants as a party to the pending action.