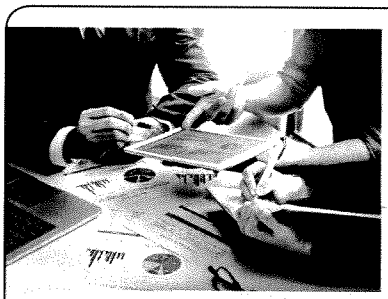
2018 Business Law Institute

November 14, 2018

NEW MEXICO
STATE BAR FOUNDATION
CENTER FOR LEGAL EDUCATION



2018 Business Law Institute

5.0 G | 1.0 EP

Wednesday, November 14, 2018 • 8:50 a.m.-4:30 p.m.
State Bar Center, Albuquerque

$99 Non-member not seeking CLE credit
$228 Early bird fee (Registration must be received by Oct.14)
$251 Business Law section members, government and legal services attorneys, Young Lawyers and Paralegal division members
$279 Standard Fee/Webcast Fee

Registration and payment for the program must be received prior to the program date. A $20 late fee will be incurred when registering the day of the program. This fee applies to live registrations only and does not apply to live webcasts.

Co-sponsor: Business Law Section

Do your business clients bring you issues involving New Mexico gross receipt taxes; minimum wage, overtime, and independent contractor status; insurance coverage, or estate planning strategies? How about recent and upcoming legislation? Have you considered the ethical aspects of representing a marijuana business? All of these topics presented by highly-regarded speakers, are on the agenda for the 2018 Business Law Institute.

8:30 a.m.	Registration and Refreshments
8:50 a.m.	**Welcome and Program Overview** *Heather Travis Boone, Chair of Business Law Section*
9 a.m.	**New Mexico Legislature: Where We Are and What's Next** *Richard C. Minzner, Rodey, Dickason, Sloan, Akin & Robb, PA*
10 a.m.	**Business Lawyers and New Mexico Gross Receipts Tax 101** *Patricia Tucker, Law Office of Patricia Tucker PC*
11 a.m.	Break
11:15 a.m.	**Wage Classifications: Laws Governing Minimum Wage, Overtime and Independent Contractor Status** *Alicia Gutierrez, Moses Dunn Farmer & Tuthill PC*
12:15 p.m.	Lunch (provided at the State Bar Center) *Business Law Section Annual Meeting*
1:15 p.m.	**Estate Planning Strategies for Business Owners** *Donald E. Swaim, Swaim & Danner PC*
2:15 p.m.	**Insurance Coverage Issues for Business Owners** *Justin D. Goodman, Professor of Law, University of New Mexico School of Law*
3:15 p.m.	Break
3:30 p.m.	**There's No Business Like Grow Business/Medical Marijuana and Other Smoking-Hot Ethics Topics for Business Lawyers (1.0 EP)** *Charles K. (Kip) Purcell, Rodey, Dickason, Sloan, Akin & Robb PA*
4:30 p.m.	Adjournment Business Lawyer of the Year Award Ceremony and Reception

CLE Information

NEW MEXICO
STATE BAR FOUNDATION
CENTER FOR LEGAL EDUCATION

Overview

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CLE Credit Information

New Mexico

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Other States and Paralegal Division

CLE will provide certificates of attendance upon request. Attendees are responsible for forwarding certificates to the organizations to which they belong.

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The issues discussed herein are intended as illustrative of the types of issues which can arise in the course of representation and are not intended to address, nor do they address the broad range of substantive issues which could potentially arise in the scope of such representation.

The authors/speakers suggest that careful independent consideration, to include a review of more exhaustive reference sources, be undertaken in representation of a client regarding this subject, and therefore the practitioner should not solely rely upon these materials presented herein.

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Speaker Biographies

Richard C. Minzner is of counsel at the Rodey Law Firm, where he has practiced since 1974. He graduated from Harvard College and Harvard Law School, practiced in Boston until 1971, and was admitted to the New Mexico Bar in 1974. From 1981- 1990 he served in the New Mexico House of Representatives including service as majority floor leader and chair of the House Taxation and Revenue committee. From 1991- 1994 he served as cabinet secretary for the New Mexico Taxation and Revenue Department.

He has mediocre skills at tennis and none at all at golf.

Patricia Tucker has practiced in the area of federal and state tax controversy work since 1972. She began legal work as a law clerk for the Trial Division of the U.S. Court of Federal Claims, drafting opinions in tax cases for a number of trial judges. She was a trial and appellate litigation attorney at the Department of Justice, Taxation Division, Washington, D.C., defending lawsuits filed against US/Internal Revenue Service for six years.

Since 1979, she has been in private practice in N.M. representing taxpayers in controversies with the Internal Revenue Service and the New Mexico Department of Taxation and Revenue. Her work includes administrative representation in federal and state tax audits, administrative appeals and hearings, compliance, collection, and criminal investigation matters, in addition to tax litigation. She has litigated tax cases before the United States Court of Federal Claims, the United States Tax Court, the United States District Court for the District of New Mexico, three federal Circuit Courts of Appeal, and in New Mexico District Court. She has recently handled both compliance and penalty audits, and appeal matters, relating to FBAR's and the OVDI program.

Ms. Tucker was an adjunct professor at the Anderson Schools of Management, Graduate Division, for 12 years, and the University of New Mexico School of Law for one year, presenting a class in federal and state tax controversy work. She currently presents monthly Gross Receipts Tax Workshops at the introductory level for small groups.
She is a participant in and supporter of the New Mexico Legal Aid Low Income Tax Clinic and its predecessor, the UNM Law School Low Income Tax Clinic, as a consultant and pro bono panel member.

Alicia Gutierrez is a native of Albuquerque, N.M. She received a Bachelor of Business Administration, with an emphasis in finance, from UNM Robert O. Anderson School of Business in 1981. Gutierrez received her J.D. from the University of New Mexico School of Law in 1986.

Gutierrez has been practicing at the Moses, Dunn, Farmer and Tuthill law firm for 30 years. Her practice focuses on representing employers on employment law issues and financial institutions in litigation matters. She also has an active real estate law practice. Gutierrez is the firm's longest female shareholder since the firm's inception in 1954.

Gutierrez received the Martindale-Hubbell AV Preeminent Attorney designation and is recognized by Martindale-Hubbell as a top-rated attorney for Labor and Employment law.

Gutierrez served on the City of Albuquerque Personnel Board, which enhanced her practice in employment law. She has been active in the New Mexico Bar Association, serving as the Chair of the Business Section in 1993-1994. She served on the editorial board of *Business Law Today* for the Business Law Section of the American Bar Association from 2011- 2014. She is currently a director for Zia Trust, Inc.

DONALD E. SWAIM is listed in the publication "Best Lawyers in America" in the areas of Tax Law and Estate and Trust Law. Swaim has an AV rating (highest available) in Martindale-Hubbell. He is also a Certified Public Accountant and worked for seven years with the Internal Revenue Service prior to becoming a lawyer.

Swaim practices primarily in the areas of estate planning, tax law, probate and trust administration law, corporation, partnership and limited liability company law, and business transactions law. Swaim also does a significant amount of work on matters involving tax-exempt organizations, private foundations and charitable trusts.

Justin Goodman is a visiting law professor and teaches civil law courses including Property, Business Associations, and Insurance law. He also teaches specialized seminars focused on preparing and writing for the Multistate Essay Exam and Multistate Performance Test of the Uniform Bar Examination. He is the faculty sponsor for the New Mexico Defense Lawyers Association Student Chapter. His research interests include Bar Exam studies and civil litigation trends and procedural changes.

Prior to teaching, Professor Goodman was in private practice in Albuquerque, New Mexico. His background includes a diverse civil litigation practice including insurance defense, property disputes, fraud investigation, general tort litigation, construction defect, employment, and domestic relations. He is admitted to practice in the state and federal courts of New Mexico.

Charles K. (Kip) Purcell grew up in Socorro, graduated from the University of Virginia in 1981, obtained his law degree from Harvard in 1984, and clerked for Ruth Bader Ginsburg on the D.C. Circuit the following year. Since 1986 he has practiced with the Rodey Firm, where he defends professional-negligence cases and serves as firm counsel. A litigator himself, he admires transactional lawyers even without fully understanding what they do for a living.

New Mexico Legislature: Where We Are and What's Next

2018 Business Law Institute November 14, 2018

New Mexico Legislature: Where Are We and What's Next?

Richard C. Minzner

Rodey, Dickason, Sloan, Akin & Robb, P.A.

Richard C. Minzner is of counsel at the Rodey Law Firm, where he has practiced since 1974. He graduated from Harvard College and Harvard Law School, practiced in Boston until 1971, and was admitted to the New Mexico Bar in 1974. From 1981 to 1990 he served in the New Mexico House of Representatives including service as Majority Floor Leader and Chair of the House Taxation and Revenue committee. From 1991 to 1994 he served as Cabinet Secretary for the New Mexico Taxation and Revenue Department.

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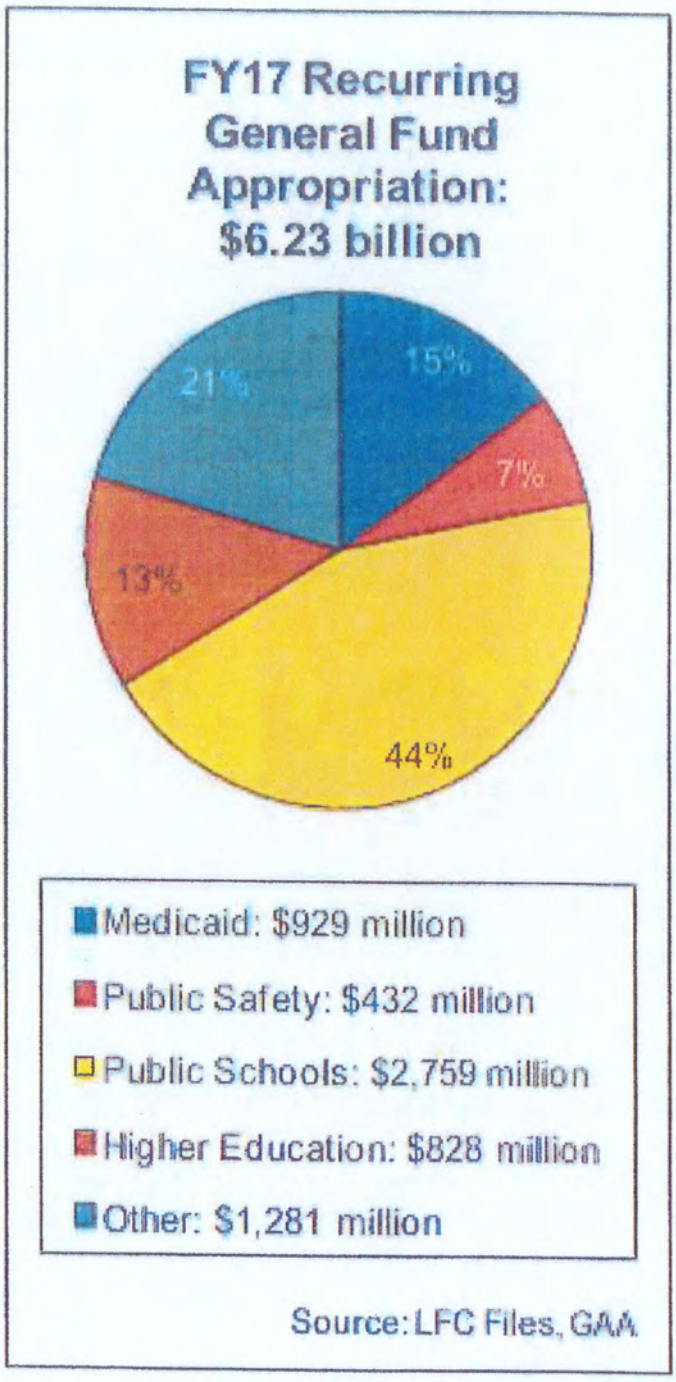
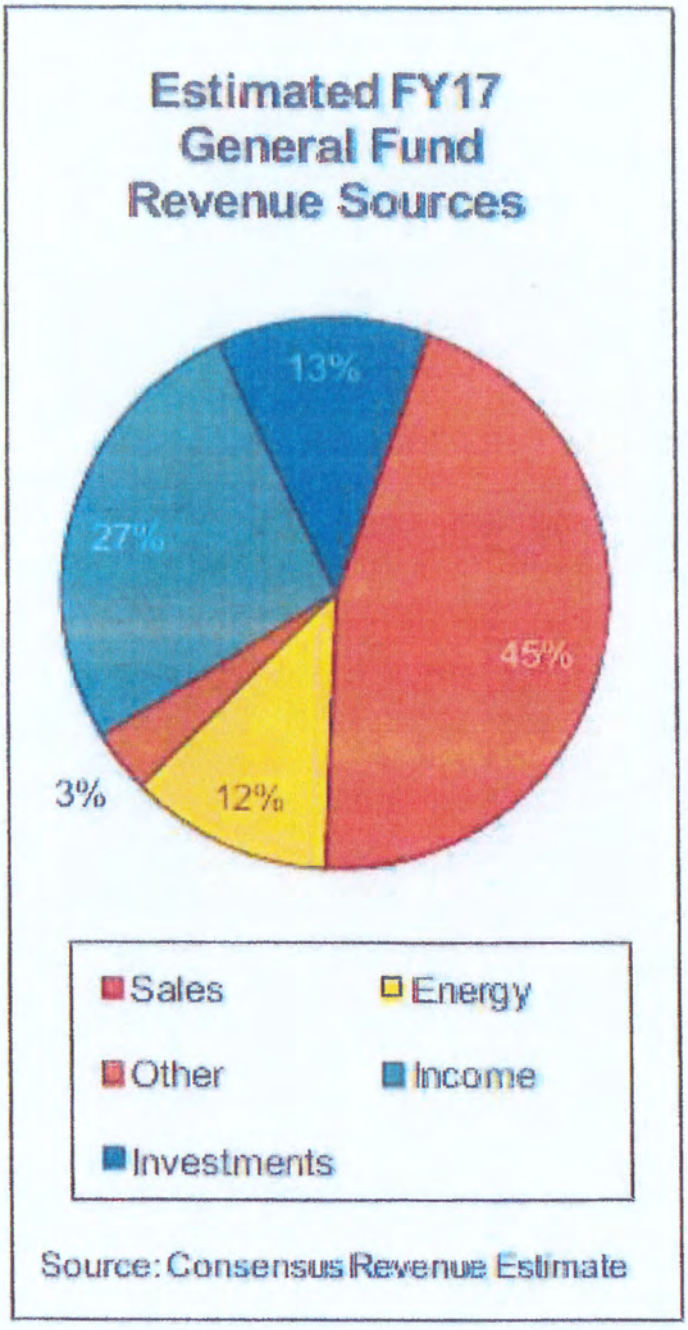
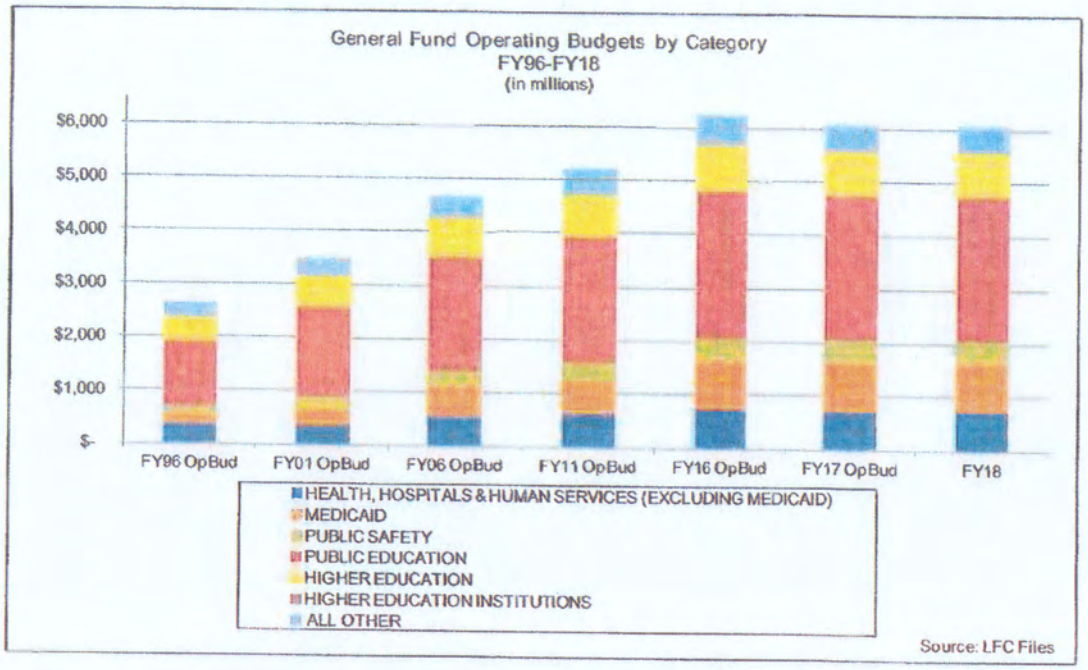
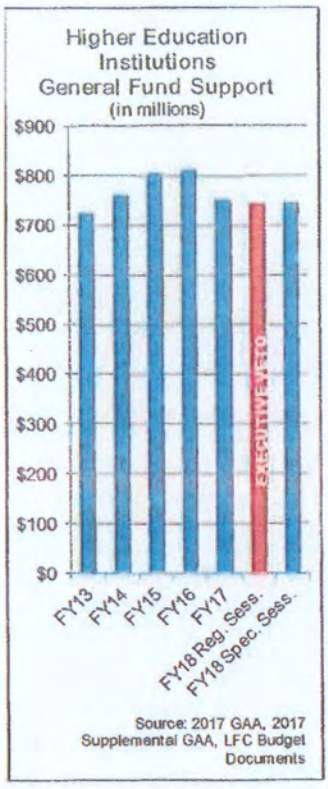
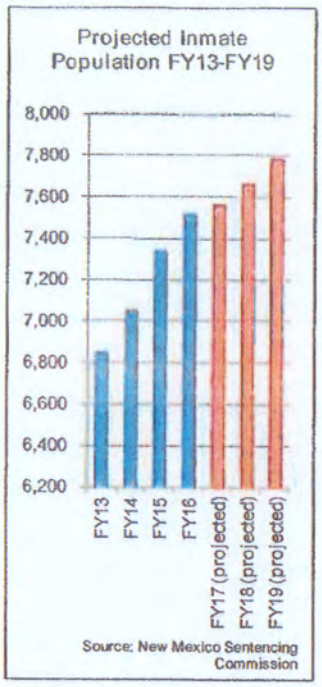
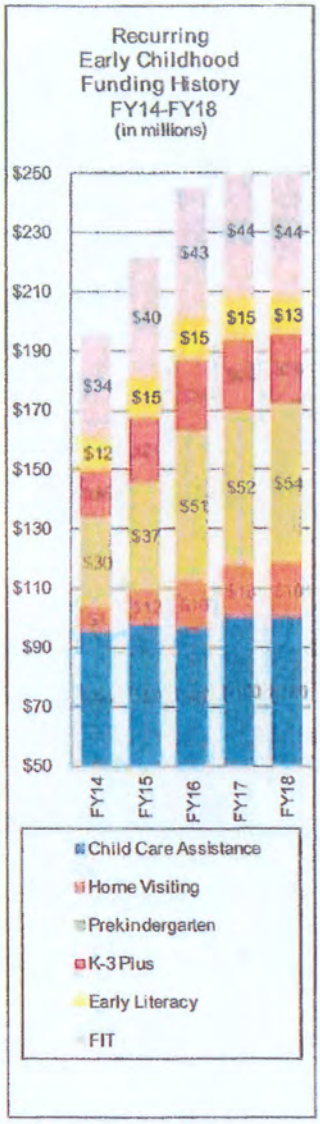

FY17 Recurring General Fund Appropriation: $6.23 billion
15%
7%
44%
13%
21%
Medicaid: $929 million
Public Safety: $432 million
Public Schools: $2,759 million
Higher Education: $828 million
Other: $1,281 million
Source: LFC Files, GAA


Estimated FY17
General Fund
Revenue Sources
13%
27%
45%
3%
12%
Sales
Energy
Other
Income
Investments
Source: Consensus Revenue Estimate


General Fund Operating Budgets by Category
FY96-FY18
(in millions)
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$-
FY96 OpBud
FY01 OpBud
FY06 OpBud
FY11 OpBud
FY16 OpBud
FY17 OpBud
FY18
HEALTH, HOSPITALS & HUMAN SERVICES (EXCLUDING MEDICAID)
MEDICAID
PUBLIC SAFETY
PUBLIC EDUCATION
HIGHER EDUCATION
HIGHER EDUCATION INSTITUTIONS
ALL OTHER
Source: LFC Files


Higher Education Institutions General Fund Support
(in millions)
$900
$800
$700
$600
$500
$400
$300
$200
$100
$0
FY13
FY14
FY15
FY16
FY17
FY18 Reg. Sess.
FY18 Spec. Sess.
Source: 2017 GAA, 2017 Supplemental GAA, LFC Budget Documents

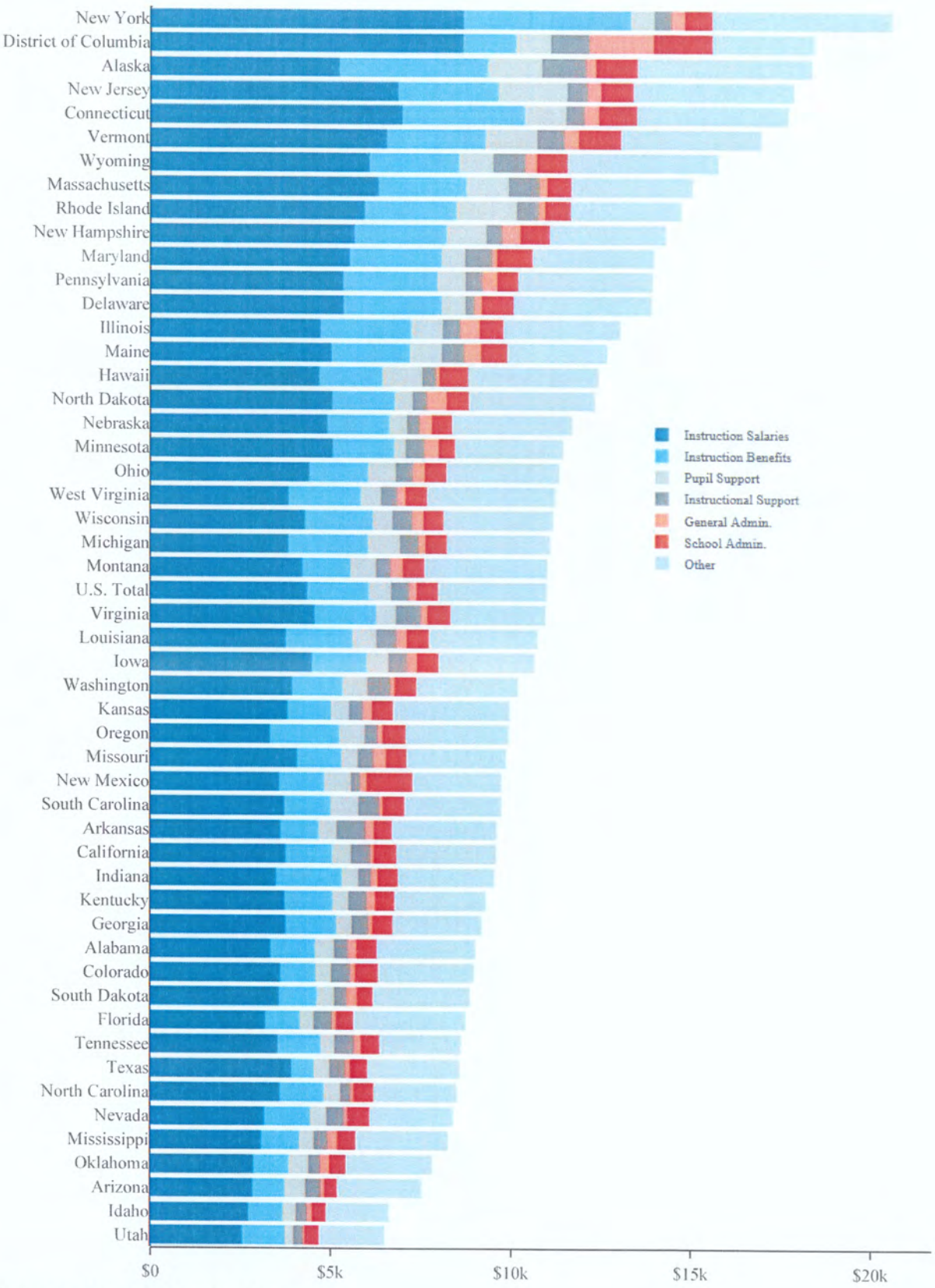

Projected Inmate Population FY13-FY19
8,000
7,800
7,600
7,400
7,200
7,000
6,800
6,600
6,400
6,200
FY13
FY14
FY15
FY16
FY17 (projected)
FY18 (projected)
FY19 (projected)
Source: New Mexico Sentencing Commission


Recurring Early Childhood Funding History FY14-FY18
(in millions)
$250
$230
$210
$190
$170
$150
$130
$110
$90
$70
$50
$34
$40
$43
$44
$44
$15
$15
$15
$13
$12
$37
$51
$52
$54
FY14
FY15
FY16
FY17
FY18
Child Care Assistance
Home Visiting
Prekindergarten
K-3 Plus
Early Literacy
FIT

Education Spending by State

NOTE: View updated 2015 data here

Nationally, the most recent data suggests $11,009 is spent on public education per student. Amounts shown cover public elementary-secondary school systems and represent per pupil spending for fiscal year 2014

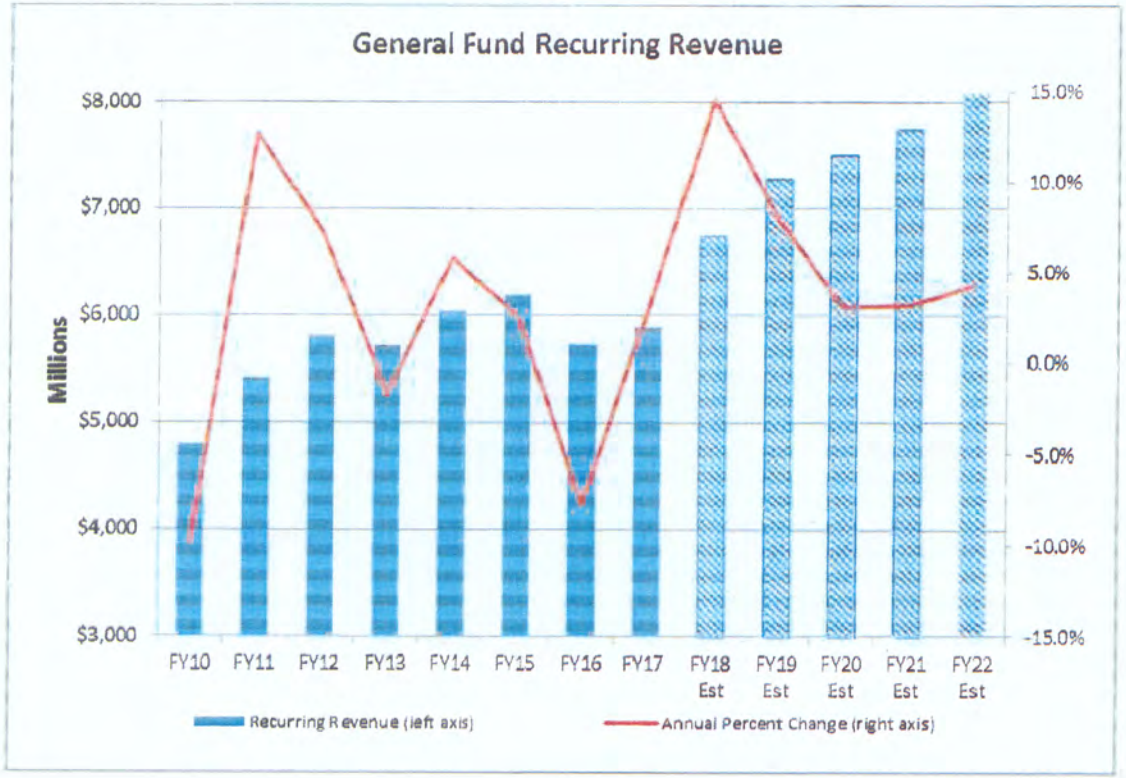


The States That Spend the Most (and the Least) on Education

by Mike Maciag | August 2016

General Fund Revenue Outlook

- Recurring revenue reached record high in FY15; will be exceeded in FY18
- FY18 total growth estimated at 14.6%.
- FY19 total growth estimated to be 8.0%.
- FY20 total growth estimated to be 3.0%



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Current and Recent
Business Issues

Current Issues

A. Benefit Corporations

B. Workplace Issues

1. Minimum Wage

2. Caregiver Leave – HB 86 (2017)

3. Right to Work

C. Marijuana Legalization

Recent Leglislation

A. Car dealership regulation – SB 27 (2018)

B. Alternative evidence for tax deductions (Other than NTTCs) – HS 194 (2018)

C. Corporate biennial report (filing date) – SB 225 (2018)

D. Data Breach – HB 15 (2017)

2017 State Tax Revenue

Note, this data includes state taxes only. Excluding local taxes can bias comparisons for some states. Users should look at Summary of Tax Burden Measurement Methods article for a better understand of how to compare state tax burdens.

	Total Taxes ($ million)	Per Capita	Rank	% of Pers. Income	Rank
Alabama	10,418	2,137	42	5.5	36
Alaska	1,190	1,608	51	2.9	51
Arizona	13,889	1,979	46	5	43
Arkansas	9,516	3,168	15	8	6
California	155,632	3,936	9	7	12
Colorado	13,198	2,354	39	4.6	46
Connecticut	16,346	4,555	6	6.6	19
Delaware	3,589	3,731	10	7.9	7
District of Columbia	7,653	11,028	1	14.8	1
Florida	40,218	1,917	48	4.2	48
Georgia	22,419	2,150	41	5.2	38
Hawaii	7,029	4,924	3	9.8	3
Idaho	4,511	2,627	31	6.8	14
Illinois	37,979	2,967	19	5.7	34
Indiana	18,052	2,708	28	6.3	22
Iowa	9,755	3,101	17	6.8	16
Kansas	8,174	2,806	25	6	29
Kentucky	11,908	2,673	29	6.9	13
Louisiana	11,105	2,371	38	5.6	35
Maine	4,233	3,168	14	7.2	10
Maryland	21,600	3,569	12	6.2	26
Massachusetts	27,518	4,012	8	6.3	23
Michigan	28,629	2,874	23	6.5	20
Minnesota	25,595	4,590	4	8.9	4
Mississippi	7,783	2,608	34	7.3	9
Missouri	12,496	2,044	45	4.8	45
Montana	2,654	2,527	36	5.9	30
Nebraska	5,103	2,658	30	5.3	37
Nevada	8,625	2,877	21	6.7	17
New Hampshire	2,497	1,859	50	3.3	50
New Jersey	32,326	3,590	11	5.9	31
New Mexico	5,776	2,766	27	7.2	11
New York	79,678	4,014	7	6.8	15
North Carolina	26,855	2,614	33	6.3	25
North Dakota	3,465	4,587	5	8.4	5
Ohio	30,306	2,599	35	5.9	32
Oklahoma	8,569	2,180	40	5.1	39

Oregon	11,915	2,876	22	6.4	21
Pennsylvania	37,853	2,956	20	5.8	33
Rhode Island	3,267	3,083	18	6.1	27
South Carolina	9,829	1,956	47	5	41
South Dakota	1,829	2,103	43	4.4	47
Tennessee	13,894	2,069	44	4.8	44
Texas	53,613	1,894	49	4.2	49
Utah	7,833	2,525	37	6.3	24
Vermont	3,128	5,015	2	10	2
Virginia	22,213	2,623	32	5	42
Washington	23,998	3,240	13	6	28
West Virginia	5,092	2,804	26	7.6	8
Wisconsin	18,133	3,129	16	6.7	18
Wyoming	1,650	2,847	24	5.1	40
Total	950,533	2,918		6	
Median		2,804		6.2	

Source: U.S. Bureau of the Census and Bureau of Economic Analysis.
Note: The Per Capita measure uses 2017 population estimated from the Census. The Percent of Personal Income measure uses 2016 state personal income from BEA.

2016 State & Local Revenue as a Percentage of Personal Income

	-Total Own Source Revenue*-			--Total Tax Collections--		
	($ million)	% Personal Income	Rank	($ million)	% Personal Income	Rank
Alabama	27,610	14.9	25	15,570	8.4	46
Alaska	7,675	18.4	3	2,827	6.8	51
Arizona	35,393	13.1	43	24,744	9.2	36
Arkansas	16,979	14.6	28	11,826	10.2	24
California	341,944	16	15	238,805	11.2	9
Colorado	39,056	13.8	38	25,558	9	39
Connecticut	31,159	12.7	48	25,905	10.6	15
Delaware	7,350	16.5	13	4,532	10.2	23
District of Columbia	9,126	18.4	4	7,419	14.9	2
Florida	117,111	12.7	47	71,847	7.8	50
Georgia	54,252	13	44	37,744	9	40
Hawaii	13,113	18.8	2	9,239	13.3	3
Idaho	8,759	13.6	39	5,903	9.2	35
Illinois	93,479	14.3	32	72,575	11.1	11
Indiana	40,290	14.6	30	25,690	9.3	34
Iowa	24,448	17.1	9	15,291	10.7	13
Kansas	20,925	15.3	20	13,069	9.6	32
Kentucky	24,661	14.5	31	16,958	10	27
Louisiana	27,935	14	34	18,219	9.1	37
Maine	8,980	15.8	18	6,953	12.2	4
Maryland	46,668	13.8	37	36,310	10.8	12
Massachusetts	59,235	13.9	35	44,142	10.4	18
Michigan	63,410	14.8	26	40,549	9.5	33
Minnesota	46,202	16.5	14	33,650	12	6
Mississippi	17,839	17.2	7	10,785	10.4	17
Missouri	34,183	13.3	41	22,430	8.7	45
Montana	5,781	13.2	42	3,972	9.1	38
Nebraska	13,991	14.9	24	9,705	10.3	19
Nevada	17,210	13.8	36	12,571	10.1	26
New Hampshire	8,850	12.2	50	6,432	8.9	42
New Jersey	78,387	14.6	29	60,238	11.2	10
New Mexico	13,541	17.1	8	8,114	10.3	21
New York	232,030	20.1	1	177,667	15.4	1
North Carolina	62,051	14.9	23	39,805	9.6	31
North Dakota	7,217	17.2	6	5,009	11.9	7
Ohio	77,756	15.3	21	51,993	10.2	22

Oklahoma	22,082	12.9	46	13,558	7.9	49
Oregon	30,035	16.8	10	18,420	10.3	20
Pennsylvania	90,845	14.3	33	64,678	10.2	25
Rhode Island	8,110	15.4	19	5,882	11.2	8
South Carolina	31,695	16.7	12	17,038	9	41
South Dakota	5,072	12.4	49	3,393	8.3	47
Tennessee	33,560	12.1	51	22,090	8	48
Texas	166,065	12.9	45	112,181	8.7	44
Utah	18,947	16	17	11,398	9.6	30
Vermont	4,902	16	16	3,680	12	5
Virginia	58,894	13.5	40	38,373	8.8	43
Washington	55,976	14.7	27	36,771	9.7	29
West Virginia	11,305	16.8	11	7,162	10.6	14
Wisconsin	39,859	15	22	27,535	10.4	16
Wyoming	5,957	18	5	3,243	9.8	28
U.S. Total	**2,317,902**	**14.9**		**1,599,449**	**10.3**	
Median		**14.8**			**10.1**	

Source: U.S. Bureau of the Census and Bureau of Economic Analysis.
* Own Source Revenues are all revenues collected by state & local government from its own sources (excluding federal transfers).
Note: The Percent of Personal Income measure uses 2015 state personal income from BEA.

NOTES

Business Lawyers and New Mexico Gross Receipts Tax 101

WHAT EVERY BUSINESS LAWYER NEEDS TO KNOW ABOUT GROSS RECEIPTS TAX

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WHAT EVERY BUSINESS LAWYER NEEDS TO KNOW ABOUT GROSS RECEIPTS TAX

NEW MEXICO GROSS RECEIPTS TAX

Chapter 7, Article 9, Sections 1 – 115.

Cautions:

- Definitions under the gross receipts tax statutes do not correspond with definitions under income tax law or under real or personal property concepts.
- The jargon used sometimes does not accurately describe the concepts that are being addressed.
- The statutory scheme is not well-organized. Provisions that belong as exclusions sometimes show up as definitional "clarifications". There is some internal inconsistency.
- Many, many of the tax Regulations are out of date and do not follow the current statute. Always check the dates of regulations and subsequent statutory changes.
- There are many specific industry or activity provisions, both for or against taxation.

Background:

- NM Selected Taxation and Revenue Law and Regulations, is a paperback publication sold by the NM Compilation Commission. It is the most useable resource because it combines the statutes with the corresponding regulations (there is no correlation in numbering) and with case and administrative precedent. A cd is included with paperback volume. It is updated once a year around June or July when new legislation becomes effective.
- Statutes with related Regulations are available online. This compilation is the most up to date – most recent revision was July 1, 2018, which includes the 2018 legislative changes. D & O's (Decisions and Orders of the Hearing Office) are available online, but are not searchable or cross-indexed.
- Forms and related materials are available online at tax.newmexico.gov, under Forms and Publications, Business Taxes, Gross Receipts and Compensating Tax, (CRS Forms or Publications or Statutes and Regulations, etc.).
- There is very, very little substantive case law on gross receipts tax issues. What there is appears mostly in the nexus and NTTC proof areas.

- Cases that go past an audit into protest are heard by a Hearing Officer and decided under a D & O, which is not precedent for other taxpayers. Few cases start in the First Judicial District Court, or are appealed to the NM Court of Appeals. Unpublished opinions are common if a case gets to the NM Court of Appeals.

- As a practical matter, gross receipts tax issues are resolved (or abandoned) in audit or protest, and almost never go to court. Because the problem can almost always be fixed prospectively, the real issue is the $$ in the audit years. Most cases just don't justify litigation from a cost perspective.

- The CRS-1 Filers package in the forms list is a comprehensive review of the gross receipts tax, including registration, audits, claims for refund, formal protests, NTTC matters, etc.

Overview:

- The purpose of the gross receipts tax is to raise revenue for the state by levying a tax on "the privilege of engaging "in certain activities" within New Mexico". Sec. 7-9-2, NMSA.

- There are three components to the gross receipts tax. The first is the state tax of 5.125 percent. Sec. 7-9-4. The rest are local option taxes imposed by counties and municipalities. Rates vary. Sec. 7-9-3F. The state collects the county and city tax portions and distributes them.

- The gross receipts tax rate for Albuquerque for the second half of 2018 is 7.8750 percent. **FYI-200 covers business locations and applicable tax rates.**

- Examples: The gross receipts tax rate of 8.4375 percent applies in Ruidosa and Sunland Park. The lowest is a rate of 5.5 percent applies in Bonito Lake, and Lincoln and Lea county outside metropolitan areas.

- **Reporting locations determine tax rates**:

    1. **One business site** in New Mexico:

        - For sale of tangible personal property and services, the reporting location is the business site location, regardless of where the buyer is or where the services were performed.

        - For leases of personal property, the reporting location is the business site location, regardless of where the property is used.

        - For lease of real estate, the reporting location is the lessor's business location regardless of where the real estate is located.

        - For sale of real estate, the reporting location is the location of the property sold.

- For construction, the reporting location is the physical location of each construction project.

2. **Multiple business sites** in New Mexico:

    - Sales from each location are reported under the business location of the sales.

    - If you have a temporary location, like a fair or a seasonal location, it is treated as a separate business location and reported under the rate for that location. A temporary location is any site where the business either rents space or advertises the business' presence for sales.

3. Other situations:

    - An itinerant peddler is someone who sells from a non-reserved location chosen for temporary periods on a first-come, first-served basis. No advertising or solicitation of the location. A peddler's business reporting location is his residence regardless of where sales take place.

    - Out of state sellers with no physical presence in New Mexico use a special reporting code of 88-888 and the state tax rate of 5.125 percent. E.g., Amazon.

Basics:

The gross receipts tax is a tax imposed on persons "for the privilege of doing business" in New Mexico. Sec. 7-9-4. "Persons" includes individuals and entities. Sec. 7-9-3 I (cap. i).

- "Gross receipts" in its simplest form is defined as the total amount of money or other consideration received from:

    Selling or leasing property (personal, real, tangible or intangible) in New Mexico;

    and

    Performing services in New Mexico;

- There are then **three "reductions"** to receipts covered by this definition in order to reach "**taxable** gross receipts". All are statutory. They are:

    1. Definitional exclusions.
    2. Exemptions
    3. Deductions

- "Engaging in business" means "carrying on or causing to be carried on any activity with the purpose of **direct or indirect benefit**". Sec. 7-9-3.3. Note that the concept of "profit-motive" is not present here.

- **Definitional exclusions:**

    1. Definition does NOT include receipts of call centers to accept and process telephone or electronic orders of tangible personal property or licenses primarily from non-New Mexico buyers, which orders are forwarded to a location outside New Mexico for filing, or to provide services primarily to non-New Mexico customers. Sec. 7-9-3.3.

    2. Definition excludes receipts of foster parents. 3.2.1.12E.

- The gross receipts tax is imposed directly on the Seller (person engaging in business who RECEIVES the compensation), and the Seller alone is responsible for paying it. Reg. Sec. 3.2.4.8.

- But, the Seller is "allowed" to charge the buyer for "gross receipts tax". This is simply a mechanism for having the Buyer provide the funds to pay the Seller's tax. This is discretionary with the Seller. The fact that the Seller may not "pass on" or "charge" the gross receipts tax is irrelevant in determining whether or not the Seller must pay it.

- **Examples**:

    1. Uber drivers. Drivers for Uber have a fee schedule set by Uber and mandatory for drivers for the amount charged to a customer. They are paid a contract percentage of the charges. The drivers cannot under the contract "add on" gross receipts tax and charge the customer for it. So drivers in NM pay a gross receipts tax on their receipts of the appropriate percentage and have no way to pass that cost on.

    2. Insurance salesmen. They are paid on a percentage commission by contract. There is no way they can pass on to the national companies a gross receipts tax imposed on the salesman. The salesperson is still liable for the gross receipts tax.

    3. Medicaid service providers (behavioral health, homecare). Medicaid services are paid for on a set rate which does not allow a provider to pass on the tax to the State. The Service provider has gross receipts in the amount of the entire payment and must report the receipts and pay the appropriate tax.

- There is no bar to the imposition of gross receipts tax several times in the course of a series of transactions. Unlike a sales tax, which is imposed ONLY once and on the "ultimate purchaser", a gross receipts tax is imposed every time there is a payment in a series of transactions unless there is a deduction or exemption applicable to the receipt at a given level. **"Pyramiding" is legal.**

- A disregarded entity for income tax purposes (e.g., single member LLC or an S Corporation) is NOT disregarded for gross receipts tax purposes. A single member LLC or an S Corporation must register with the Department and pay gross receipts tax under its own number.

- When the seller is a sole proprietor, liability is the personal liability of the owner. The general partners of a partnership are also personally liable for the gross receipts tax liability of the business.

- However, when the seller is a limited liability entity like an LLC (even a single member LLC), corporation or limited partnership, only the entity is liable for gross receipts tax as long as the entity has its own registration and reporting number. Owners, members, shareholders, or limited partners are NOT personally liable for gross receipts tax of the entity. If the entity closes with no assets, the gross receipts tax is not collected from the shareholders, members, limited partners, etc.[1]

- There is no "recovery penalty" provisions for gross receipts tax. There may be direct liability on the "successor in business" of the business, under circumstances discussed below.

- The statutory scheme is (1) the **definition** of gross receipts, after definitional exclusions; (2) less **Exemptions** to reach (3) **reportable** gross receipts, less (4) **deductions,** to reach (5) taxable gross receipts.

- "Exemptions" and the "deductions" are both matters of legislative grace only. If there is not an exemption or a deduction in the statutes specifically addressing the receipt, any receipt within the definition of "gross receipts" is taxable.

- A business which has "reportable gross receipts" (gross receipts less exemptions is a positive number) must register with the department and file gross receipts reports (CRS-1's) even if no tax is owed because all receipts are covered by legitimate deductions.

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[1] There is a separate statute under which the state can assess a penalty against an operator of a limited liability business in the amount of unpaid gross receipts tax liabilities if the nonpayment is deemed to be evil to the extent that the operator has aided and abetted the entity in evading gross receipts tax. Sec. 7-1-72.1. There is also a criminal charge for the same violation. I have never seen it used since enacted in 1997. Nobody knows what it means. The regs. basically say that it can be used if the business continues after the operator knew that there would be a problem paying gross receipts tax and didn't move to close the business within a few months.

SUBSTANTIVE MATTERS:

Definition of Gross Receipts for Gross Receipts Tax Purposes:

Gross receipts (Sec. 7-9-3.5A(1)) means the "total amount of money or the **value** of other consideration" received from:

- **Selling property in New Mexico.**

  Property includes real property, tangible personal property, licenses, franchises, and other intangibles.

- **Performing services in New Mexico.**

  Services includes construction services and all construction materials that will become part of a construction project.

- **Leasing or licensing property employed in New Mexico.**

  Leases of real and of personal property are both included in the definition.

- **Selling services performed outside New Mexico if the product is R & D and** the initial use of the product of the services is in New Mexico.

- **Granting a right to use a franchise employed in New Mexico.** The franchisor is subject to gross receipts tax on its receipts from the franchisee (even if the franchisor is out of state) and the franchisee is subject to gross receipts on its sale income.

Definitional clarifications and exclusions:

Gross receipts DO include (sample of those listed):

- Receipts from the sale of tangible personal property handled on consignment. This is the gross proceeds, before the cut for the consignor. The consignee's portion is gross receipts to the consignee. Admin. Regs. 3.2.1.15B.

- Commissions and fees as a broker or agent on any property, service, stock, bond, or security.

- Amounts paid by members of cooperative associations for sales or leases of personal property or for services.

- Receipts on transactions between related parties even if consideration was not received in cash or property.

- The full fee for sale of goods and services paid by credit card, including the amount charged by the credit card company. There is no deduction for that fee for gross receipts tax purposes.

- Amounts received by a NM florist from sale of products when the NM florist takes the order even if the order is filled by an out of state florist and delivered out of state.

- Receipts that were embezzled or lost through bookkeeping errors are gross receipts. They are not cash discounts and are not refunds, allowances or uncollectible debt which may be otherwise deductible. 3.2.1.14J.

Gross receipts does NOT include (Sec. 7-9-3.5A and Regs. 3.2.1.14):

- cash discounts.

- tax due on receipts that are taxable. A formula backs out the tax component of receipts in computing gross receipts under this definition.

- amounts received "solely on behalf of another in a disclosed agency capacity". Sec. 7-9-3.5A(3).

- amounts received by a New Mexico florist from filling orders from an out-of-state florist for filling and delivery in New Mexico.

- Receipts from fundraising activities of not for profit organizations (OTHER than 501(c)(3) organizations – charitable, educational, etc.) if the funds raised are in the nature of donations, gifts, or contributions. This includes the donation portion of sales of products. Admin. Regs. 3.2.1.14H.

Examples from the regulations, many of which are basically **definitional exclusions**, but some of which are **clarifications,** include:

- Receipts from a lease/purchase agreement are gross receipts from the sale of personal property if the user depreciates the property and treats it as a capital asset.

- Receipts from the sale of postage stamps for over face value are gross receipts.

- Receipts from insurance proceeds are not gross receipts.

- Receipts from the sale of gift certificates are not gross receipts. When the certificate is redeemed, the proceeds are then gross receipts to the redeeming business.

- Receipts from the rental of a license, such as a liquor license, or from a franchise agreement, are subject to gross receipts tax. Admin Regs 3.2.1.17C.

- Receipts from the rental of property used in NM are gross receipts even if the lessor is an out of state person or entity and the agreement was signed out of state.

- Where leased vehicles are used in NM and outside NM, the receipts must be allocated and the allocation to NM use are gross receipts to the lessor.

Special provisions related to receipts from the provision of services (Admin Reg 3.2.1.18):

- Receipts from services performed both within and without New Mexico are subject to apportionment.

- Directors, trustees, and Personal Representative fees are gross receipts to the extent paid for services performed in New Mexico.

- Receipts of day care centers or day care providers are subject to gross receipts even if the provider receives state funds (like Medicaid) and cannot charge the state for the gross receipts tax.

- Receipts of an employer for day care services provided for the use of its employees are gross receipts.

- **TIPS ARE NOT GROSS RECEIPTS**. They are gratuities in the nature of a gift. Admin. Reg 3.2.1.18R.

- Receipts of entertainers are gross receipts if the performance took place in New Mexico.

- Commissions received by agents of entertainers for their services performed in New Mexico are subject to gross receipts tax.

- Receipts from winning a rodeo or athletic game in New Mexico are gross receipts if a charge is made for attendance.

- Commissions received by real estate brokers are gross receipts. There is a partial exclusion discussed below.

- **Reimbursed expenses** ARE gross receipts unless the cost was incurred in a disclosed agency capacity. Admin. Regs 3.2.1.19C.

    1. Example: reimbursed postage expense is gross receipts.

    2. Example: reimbursed travel expense is gross receipts.

    3. Example: reimbursed court filing fee is not gross receipts if fee is identifiable as an expense of the client. Attorney is an agent.

    4. Example: receipts for a per page fee for the costs of copying done in office are not reimbursed expenses. They are receipts from the provision of copying services and are gross receipts even though characterized as costs. Same for charges for electronic research and delivery services.

Federal preemption exclusions:[2]

- Receipts from sales of personal property in transactions with Indian Tribes or member of tribe on tribal land.
- Receipts from leasing of property to tribe or member on tribal land.
- Receipts from provision of services on tribal land or to member on tribal land.
- Receipts from Indian business on tribal land if business is owned 50% or more by member.
- Receipts of a federal credit union.

What is an "activity" in New Mexico? An activity is engaging in any of the following (Sec. 3.2.13.8), either directly or through an agent:

- Maintaining or utilizing an office, distribution house, sales house, warehouse, service enterprise, or other place of business;
- Maintaining a stock of goods;
- Regularly soliciting orders whether or not such orders are accepted in New Mexico, unless the activity consists solely of soliciting by direct mail;
- Regularly engaging in the delivery of property in New Mexico, other than by common carrier or US mail as a result of an advertising or other sales program directed at potential customers.

VALUE is the reasonable value of the consideration received if the money or other consideration doesn't represent the actual value of the property or service exchanged. Sec. 7-9-3.5(A)(1) and Admin. Reg. 3.2.1.14(C) and (D).

- Gross receipts is the full fair value of consideration, even if less is paid or charged.
- Example – X, a garage owner, repair's Y's auto in exchange for a rifle. The fair market value of the rifle is $100. Gross receipts of the garage owner is $100.
- Example – X is a land and cattle company, and is a corporation affiliated with Y, an equipment company. Because of their affiliation, X leases a $30,000 tractor from Y for $1 a month. Y's gross receipts are the market value of a monthly lease of a $30,000 tractor.
- Example – Joe performs 5 hours of legal services a month for Carrie, a CPA. Carrie performs 10 hours of bookkeeping a month for Joe. Joe's regular fees are $200 an

[2] Think of these as "not in New Mexico" because tribal lands are not considered state lands.

hour. Carrie's regular fee is $100 an hour. No money changes hands. Joe and Carrie each have gross receipts of $1,000 a month.

Exemptions:

- All exemptions are **statutory** and are contained in Sections 7-9-13 through 7-9-42.

- **Reportable gross receipts** are definitional gross receipts for which there is no exemption. They are reported in column D of the CRS-1 form. Receipts subject to exemptions are not included in reportable gross receipts, no return has to be filed, and no registration is required.

- Exemptions may be industry specific (e.g., agriculture, aerospace), intuitive (things included in the definition of gross receipts, but which are not considered "doing business" in the ordinary course of things), or just plain arbitrary from strong lobbying or for "industry encouragement" purposes.

- These are the most common exemptions:

    1. Receipts of employees for wages, salaries, commissions, and compensation for services.

       Employment status is defined similarly to the definition for federal employment tax purposes. As a practical matter, where an activity is treated as producing W-2 income for federal income tax purposes, the state will accept that classification.

       However, where receipts are reported on a Sch. C, and there has been no determination of employment status such as under an SS-8 determination, arguing that the real classification should be employee status will not be successful with the state. Gross receipts tax will be imposed.

       Be careful of trying to get reclassification of the worker as an employee to avoid gross receipts tax. While a worker may save 7% or so in gross receipts tax, and not be subject to self-employment tax, the worker may end up overall increasing income and employment tax by more than the amount of the gross receipts tax saved.

       If a worker is reclassified as an employee, the worker does not have to pay self-employment tax, but the worker (1) loses the income tax deduction for one-half of his self-employment tax; (2) loses business expenses that will not be deductible under the unreimbursed employee business expense deduction (due to percentage reduction or nature of expense or not itemizing); and (3) is subject to a tax for "uncollected FICA/Med. tax", which is equal to an employee's share of fica/med withholding. The situation overall may be a wash or worse for the worker.

2. Interest, dividends, and receipts from the sale of stock and securities. Sec 7-9-25.

3. Receipts from gate, concessions, merchandising, etc., from operation of a minor league baseball stadium, and receipts from tickets, parking, advertising, and other products and services at a municipal event center.

4. Sale of required textbooks to students by bookstore operating on campus.

5. Receipts of nonprofit entities from operation of facilities designed and used for providing accommodations for retired elderly persons.

6. Receipts of a university from an athletic facility surcharge imposed under the University Athletic Facility Funding Act.

7. Agricultural exemptions:

    - Receipts from sales of livestock.

    - Receipts of growers, producers, and trappers from selling live poultry, unprocessed agricultural products (bale of hay, head of lettuce, **unroasted** sack of green chili, hides or pelts).

    - Receipts from feeding or pasturing livestock (e.g, feed yards, receipts from penning, handling or training livestock).

    - This exemption does **not** exempt receipts from the sale of pasteurized dairy products or roasted green chili. Those are processed agricultural products.

8. Receipts of disabled street vendors.

9. Receipts of retailers from the redemption of food stamps.

10. Receipts from sale of fuel of various kinds (most are subject to excise taxes by the state).

11. Receipts of a home-owners association for common upkeep.

12. Isolated or occasional sale or leasing of property or services by a person not engaged in the business of selling or leasing the same or similar property. Sec. 7-9-28.

    "Isolated" for this purpose depends on several factors, but certain specific guidelines are included in the regulation.

    - E.g., receipts from the lease of **three or fewer rental units** is considered an occasional sale if the person is not regularly

engaged in the business of leasing real property.

- Personal Representative fees, trustee fees, and administrators fees are NOT exempt under this section because the positions are of long enough duration to constitute engaging in a business.

- Two garage sales a year are excludable under this exemption because the sales do not rise to the level of engaging in business.

- A person holding a license to engage in the activity is holding himself out as doing business under the license, no matter how seldom. An example is an attorney who is a full-time employee of a corporation, but takes a couple of criminal cases a year outside the employment to keep up his trial skills. He is not regularly engaged in business per the regulations, but because he is holding himself as licensed to do legal work he is not entitled to this exemption. Admin. Reg. 3.2.116.9, Example 4.

- Rent-a-Center rents lawnmowers. Once, and only once, it sold a used lawnmower to a customer. The sale receipts cannot be excluded because the seller is in the business of leasing "similar property".

13. Receipts from dues and fees charged by non-profit social, fraternal, professional, etc., clubs (7-9-39) and receipts of a minister from performing religious services. Sec. 7-9-41.

14. Receipts of horsemen, jockeys, and trainers from race purses at NM horse racetracks and receipts of racetracks from gross amounts wagered.

15. **Governmental Entity Exemptions:**

    Receipts OF sales by the federal government, the State of New Mexico, or any Indian tribe or reservation (if made ON the reservation), or agencies or instrumentalities thereof, are exempt from the gross receipts tax. No tax on the governmental or tribal agencies.

16. **Nonprofit organization exemption:**

    Receipts of a minister from performing religious services are exempt.

    Receipts from sales of goods or services by organizations granted **501(c)(3)** recognized organizations are excluded after 1970 unless receipts are from an unrelated trade or business. Sec. 7-9-29.

17. Receipts from the sale of vehicles and boats are exempt from gross receipts tax. They are subject to excise taxes.

18. Receipts from the sale of services performed outside the state the product of which is initially used in the state of NM, other than certain R & D projects. Sec. 7-9-13.1.

Deductions:

Deductions are allowed **only** by specific statute. Over **70 percent** of the statutory provisions for gross receipts tax relate to deductions in one way or another.

There are two basic groups of deductions. Both are subject to audit for substantiation as to amount and qualification. Some deductions can be claimed on the basis of actions and knowledge of the seller. Some require actions or knowledge known only by the buyer. The latter require certain certification (NTTC) by the buyer before a deduction can be sustained.

First group of deductions:

The following are the most common deductions **allowable without certification** by the buyer:

- **Receipts from the sale or lease of real property**. Sec. 7-9-53.

  Receipts from the sale or long-term lease of real property may be deducted. Note that this means that if an entity with more than 3 units or properties leased, the rent is gross receipts and has to be reported, but it is deductible.

  Exception - the portion of the receipts from the sale of real property that is attributable to improvements **constructed** on the real property by the seller in the ordinary course of the Seller's business is NOT DEDUCTIBLE by the Seller. This applies to new construction. The portion attributable to real estate and all else is deductible.

  Example – a contractor builds a residence on fee-owned real estate. The residence is sold to the ultimate user. The entire purchase price received is reportable gross receipts. A deduction may be taken for the value of the land. The value of the improvements may not be deducted.

- Receipts from **commissions** paid to non-employees on the sale of real estate may be deducted only to the extent commensurate with the non-taxable portion of the underlying sale. Sec. 7-9-66.1.

  Example: Realtor receives a commission of $100 on the sale of a residence by a contractor. The entire commission constitutes reportable gross receipts. The Realtor may claim a deduction for that part of the commission that is allocable to the sale of land, not the part allocable to the sale of the improvements. The percentage follows the contractor's allocation.

  Example: The same Realtor sells a residence which is not new construction by the seller. The entire commission may be deducted.

- Sale of **services to an out of state buyer**. Sec. 7-9-57.

    1. Acceptable information may be produced to prove that the buyer is an out-of-state buyer.

    2. Per the regulations, acceptable information includes invoices showing invoicing to an out-of-state client, copies of checks showing an out of state address, and contracts showing an out of state address. Recently Taxation and Revenue Department has requested a letter from the issuer of the Form 1099 attesting to the fact that it is an out-of-state buyer and other proof such as advertising or website to show that operations were located out of state.

    3. The statute requires documentation that the service was not first used in NM. In practice, this is most often inferred from the identity of the buyer and the type of service sold.

- Receipts from the sale of tangible personal property to the United States, the State of New Mexico, or any governmental unit or subdivision thereof is deductible. Receipts from the sale of tangible personal property to an Indian tribe, pueblo, or agency of department thereof for use on the reservation are deductible. Sec. 7-9-54.

  Note that this provision **does NOT apply to sale of services or leases** to the same entities.

  Example: Receipts from the sale of dentures to a state prison be used for inmates' dental work may be deducted. Receipts from the payment for the services of fitting the dentures may NOT be deducted.

  Receipts from the lease of tangible personal property to a governmental agency are not deductible.

  Receipts from the sale of a license to the government are not deductible because a license is intangible property, not tangible personal property.

- Half of the receipts of hospitals may be deducted from gross receipts. The deduction is applied only after all other deductions are taken. Sec. 7-9-73.1.

- **Certain** receipts for services provided by **health care practitioners** may be deducted. Sec. 7-9-93. Note – this deduction depends on the identity of the entity paying the charges and the type of charges paid.

  1. Receipts from a managed health care provider or health care insurer for contract services (negotiated rates) or Medicare part C medical services provided by a health care practitioner are deductible.

  Note that receipts from Medicaid funds are NOT deductible even if paid by an insurance company. The statute expressly states that no receipts for services provided to Medicaid recipients are deductible.

2. Fee-for-service receipts are NOT deductible. (Non-insurance payments, self-pay, etc.)

3. Examples –

A. A physician collects a fee from an HMO or insurance company on a negotiated fee schedule. The physician may claim a deduction for those receipts.

B. The patient pays a $20 co-pay on the same services. The co-pay is not deductible. The doctor may pass the tax on the co-pay on to the patient but most insurance contracts will not allow that.

C. The same physician is paid by the patient who does not have insurance for the same services on a full charge basis. No deduction can be taken. The doctor may pass the tax on the charge on to the patient.

- Receipts from the sale of food by a retail food store may be deducted but must be separately stated on the CRS-1 form. Sec. 7-9-92.

- **Aircraft deductions**. There are a number of deductions for the aircraft and aerospace industries. All receipts of an aircraft manufacturer or affiliate from selling aircraft or aircraft flight support, pilot training or maintenance training may be deducted. 7-9-62B.

  There is a deduction for 50% of receipts from other sales of aircraft and receipts of an airplane manufacturer from selling parts and services. Sec. 7-9-62A.

- There are a number of **agricultural deductions**, including the following:

  1. Receipts from <u>selling feed</u> for livestock (including horses), or for animals raised for their fur or pelts, fish raised for human consumption, seeds, roots, germicides, and water for irrigation, sold to a person in the business of farming or ranching. Sec. 7-9-58. (The buyer has to state in writing that he is engaged in the business of farming or ranching, but no NTTC is required.) Sec. 7-9-58.

  2. Receipts from warehousing, threshing, growing, cultivating or harvesting agricultural products. Sec. 7-9-59.

  3. 50% of the receipts from selling agricultural implements, farm tractors, and equipment to persons engaged in farming or ranching. Sec. 7-9-62A.

  4. Receipts from the sale of veterinary services performed for <u>cattle</u> owned by a person engaged in the business of ranching or farming may be deducted. Receipts from treatment of other animals are not deductible. Sec. 7-9-109.

- Receipts from producing or staging professional boxing, wrestling or martial arts contests that occur in New Mexico can be deducted, including receipts from ticket sales and broadcasting. Sec. 7-9-107.

- **Internet deductions:** Receipts from the sale of a service or property through the internet to a person with a billing address outside New Mexico are deductible. Receipts from hosting web sites are deductible. 7-9-56.2 and 57.1.

Second group of deductions require NTTC's:

The SECOND GROUP of deductions depends on the **identity of the buyer and/or on the use to which the buyer will put the property or service purchased.** In these cases, only the buyer knows if the property or service will be utilized in such a way that the seller can claim the deduction or if it qualifies as a protected buyer.[3]

Because the seller has no direct knowledge of the way the property or service will be used, or knowledge as to the qualification of the buyer, the law allows the purchaser to "Certify" that the use or the buyer will conform to the statutory deduction rules.

A seller can rely on those certificates even if the buyer does not conform use to the certification or does not in fact qualify to issue the certificate.

These certifications are made through the use of Non-Taxable Transaction Certificates (NTTC's) issued by the Department. The records of issuance are now kept on-line and are searchable.

Qualifying receipts in this group can be deducted **only** if the deduction is supported by the **possession** of an NTTC of the correct type which the Seller obtains from the buyer.

- Only three kinds of certificates are acceptable:

    1. Certificates issued by T & R, on its forms. The Department now has on-line registration and issuance procedures.
    2. Multi-jurisdictional uniform sales and use tax certificates (MTC's)
    3. Border states uniform sale for resale certificates (BSC's)

    No other forms are acceptable to the Department. No letters from the buyers, no other "documents of certification", will be sufficient.[4]

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[3] The purchaser will not want the seller to charge gross receipts tax on the purchase. So, to avoid this, the purchaser has to certify that it will use the product or service in the required way, or certify that it is a qualified buyer.

[4] One exception, noted above, is that for sales of tangible personal property to a government agency etc., either an NTTC or other evidence is acceptable. Note also the definitional exclusion for sales to Pueblos, etc., in some cases.

- NTTC's are issued by the Buyer and given to Seller. They are required to be in the possession of the Seller -

    1. by the time the return is filed or, if not,

    2 by 60 days after the production of such certificates is demanded (in an audit).

    3. If the NTTC was issued online through the Department, that is the equivalent of "being in the possession of the taxpayer".

- Until 2018, there was no statutory alternative to producing the correct NTTC within the 60 day period to support a claimed deduction, other than for sales of tangible personal property, where other evidence was sometimes found sufficient.

- Effective March 3, 2018, the statute was changed to provide that in the absence of a qualifying NTTC, other evidence could be used to prove entitlement to the deduction.

- Although a recent D & O held that the new statute covered only transactions which occurred after that date, as a practical matter, the Department and Hearing Officers are allowing alternative proof in lieu of an NTTC as long as the actual payment of tax by the buyer is proven.

There are 9 types of NTTC's currently used by the Department. Each covers a number of statutory deductions. There are four which are most often used.

Deductions that have to be supported by a non-taxable transaction certificate (NTTC):

Type 9 NTTC's: The "qualified buyer" deduction.

- Receipts from the sale of **tangible personal property** to:

    1. a federally recognized **501(c)(3) organization** (Sec. 7-9-60);

    2. **a federal or state-chartered credit union** (Secs. 7-9-54 and 61.2);

    3. **an agency or instrumentality of the state or federal government** (Sec. 7-9-54); or

    4. **Indian tribes, nations or pueblos** when purchasing tangible personal property for use on reservations or pueblo grants (Sec. 7-9-54)

    may be deducted.

- To be deductible, the buyer must deliver a **Type 9 NTTC** to the seller. This certifies that the buyer is a qualified organization and in the case of Indian tribe etc. purposes, that the property will be used on the reservation.

- Note that this covers tangible personal property only. It **does not cover** sale of services, lease of property, or use of intangibles.

- Example: A restaurant delivers lunch to a meeting of the directors of Animal Humane Society of New Mexico. The receipts from the sale of the food are reportable gross receipts, but can be deducted if the Society gives the restaurant a Type 9 NTTC. Receipts from delivery charges are reportable gross receipts but **cannot** be deducted because they are receipts from the provision of services.

Type 2 NTTC's: The "personal property" deductions.

- **Sale of tangible personal property or license for resale** in the ordinary course of business. The buyer must certify through a **Type 2 NTTC** that the property will be resold in the ordinary course of the buyer's business. Sec. 7-9-47.

  Example: A wholesaler sells prescription dog food to a veterinary clinic. If the veterinary clinic provides an NTTC attesting to fact that the dog food will be resold in the ordinary course of the veterinary business, the wholesaler may claim a deduction for the receipts.

  Example: If the seller sells the same food to an animal boarding facility for use in its boarding activities, the buyer cannot issue a non-taxable transaction certificate because the dog food is to be consumed, not resold.

  There is one and only one limited exception to the "produce the NTTC or else" rule under the pre-2018 statute, and it doesn't work where the seller is still in business. In situations where the deduction would be based on "sale of personal property for resale", if an NTTC cannot be produced, an acceptable substitute for the NTTC could be:

  1. Proof that the buyer is out of business and the deduction was appropriate.

  2. A letter to the buyer inquiring as to the disposition of the specific property, specific invoice numbers, copies of purchase orders, identification of property, statements of resale, etc. The list is extensive. See Regulation 3.2.201.10.

  3. Any other documentation that has been approved by the Department in writing prior to an assessment or a protest that has been acknowledge by the Department.)

- Sale of **tangible personal property** to a person engaged in the business of **manufacturing.** The personal property must be incorporated in the manufactured product as an ingredient or component part. The buyer certifies that the property purchased will be so used through a **Type 2 NTTC**. Sec. 7-9-46.

  Manufacturing is defined as the combining or processing components or materials to increase their value for sale in the ordinary course of business, but does NOT include construction. 7-9-3.H.

Combining is defined as assembling two or more pieces of tangible personal property to create another piece of personal property. Example – putting individual objects into a gift basket to sell as a package. Regs. 3.2.1.25A.

Processing is defined as converting tangible personal property into a marketable form. Examples – a boat builder buys fiberglass and wood to use in building a boat for ultimate sale to customers. An artist buys paint and canvas for use in making pictures for sale. Both are manufacturers. Regs. 3.2.1.25.

- Sale or lease of **tangible personal property or licenses for subsequent lease** in the ordinary course of business (exceptions for furniture or appliances, coin operated machines, or purchase of manufactured homes). Sec. 7-9-49 and -50.

  Example – Seller of a lawn mower to Rent-A-Center may deduct the receipts on the sale if the buyer issues a **Type 2 NTTC** and subsequently leases the item in the ordinary course of business.

  Example: Tire retailer sells tires to Avis Rent-A-Car for use in vehicles which are leased to the public. Avis has to issue an NTTC to the retailer in order for the retailer to claim a deduction for those receipts.

Note that for these types of transactions **there is no requirement that the "resale" or "release" be in a transaction which is subject to gross receipts tax.** The resale may be under a Type 9 NTTC, for example.

Type 5 NTTC's: The "services" deductions.

- **Sale of a service for resale.** The buyer who delivers the **Type 5 NTTC** must resell the service in the ordinary course of business **and the resale must be subject to gross receipts tax. Sec. 7-9-48.**

  Example: Sale of installation services to a spa retailer. The retailer bills the customer for the "installed spa".

  NB: The Regulations have not been amended to reflect that the statute was amended to remove the requirement that the charge for services be separately stated on the invoice for the resale. Any references to separate statement in the regulations may be ignored.

  The receipts from the **first** subsequent sale **must be subject to gross receipts**. The buyer "certifies" that that the services will be resold in a transaction subject to gross receipts tax. Note that if the subsequent sale is not subject to gross receipts tax, the seller can still claim a deduction if it accepted the NTTC in good faith. The buyer issuing the NTTC, however, will owe compensating tax for not honoring the NTTC assurances.

- **Sales of Services performed on a manufactured product to a Manufacturer** may be deducted if the services are performed directly upon tangible personal property it is in the business of manufacturing or upon ingredient or component parts thereof. Sec. 7-9-75.

  Example – Joe's Painting Services paints picture frames for an artist who is in the business of selling his own artistic creations already framed. The artist is a manufacturer. Joe's Painting is selling a service to a manufacturer which is performed directly on tangible personal property which is being "manufactured". Joe's can claim a deduction if issued a **Type 5 NTTC** by the artist.

Type 6 NTTC's: **Construction** contractors may issue NTTS's for:

- **Purchase of construction materials** that will become ingredients or components of a construction project that is either subject to gross receipts tax on completion or that takes place on Indian Tribal land. Sec. 7-9-51.

  Example: A wholesaler sells doors and windows to a commercial construction business. The wholesaler can claim the deduction if it receives an NTTC from the construction business certifying that the product sold will be used in the product being constructed, etc.

- **Purchase of construction services** which are directly contracted for or billed to a construction project that is either subject to gross receipts tax upon completion, upon sale in the ordinary course of business of the real property on which it is constructed, or on Indian land. Sec. 7-9-52.

  Examples – surveying, architectural plans, engineering, drilling water wells, grading.

- **Lease of construction equipment** to persons engaged in the construction business. The lessee must certify, using an NTTC, that the equipment will be used its construction business. Sec. 7-9-52.1.

  Example: Scaffolding company rents scaffolding to a construction company for use in its construction products.

Mechanics:

- **Registration.** Sec. 3.2.100.8 of the Regulations. Business Reg. Update.

  1. A person who receives only funds which are not within the definition of gross receipts, or are within the definition, but which are subject to a statutory exclusion, **do not have to register** with the Department and do not have to file CRS-1 reports.

2. Otherwise, if receipts are within the definition of gross receipts, but are not subject to an express exemption, registration and the filing of CRS-1 reports are mandatory. This applies even if all receipts will be deductible and not tax will be due.

3. Registration is required in order to issue NTTC's even if the issuing business does not have to otherwise register.

4. Registration is required if wages are to be paid.

- **Timing.** Sec. 7-9-11.

  1. Reports and taxes are due on the 25th day after the close of a month.

  2. Taxpayers with a tax liability of an average of under $200 a month and have been granted the authority may report and pay on a semi-annual or quarterly basis.

- **Accounting method.** Cash basis taxpayers report on the cash basis. Accrual basis taxpayers report on the accrual basis. Reg. 3.2.2.14. Audits are on cash basis with adjustments for accrual.

- **On-line filing is required if monthly filing is required.** Monthly filing is required if average monthly liability is $200 or more. Penalties apply for attempts to file on paper. See Pub. 108, Ex. 2. Payment may be made on-line, by check, or other means of payment.

Successor in business liability:

The gross receipts tax liability of Business A can be collected from Business B if B is a "successor in business" of A. Sec. 7-1-61.

This can happen when a business with outstanding gross receipts tax liability sells assets. It can happen where business assets are sold for full fair market value. It can also happen with a business closes, but a person, or another entity, is formed which takes on some or all of the assets, tangible or intangible, of the now defunct first entity, or performs the same work, by purchase or otherwise.

This is the statutory scheme:

> **Sec. 7-1-61(B):** The tangible and intangible property used in any business remains subject to liability for payment of the tax due on account of that business to the extent stated herein, even though the business changes hands.

Sec. 7-1-63(C): A successor may discharge an assessment made pursuant to this section by paying to the department the full value of the transferred tangible and intangible property.

The successor shall remain liable for the **entire amount** assessed, however, until the amount is paid if:

(1) the business has been transferred to evade or defeat tax;

(2) the transfer of the business amounts to a de facto merger, consolidation or mere continuation of the transferor's business; or

(3) the successor has assumed the liability.

Regulation Section 3.1.10.16F, promulgated under Section 7-1-61 NMSA, provides that for the purposes of both Section 7-1-61 and Section 7-1-63, NMSA, the "mere continuation test" is determined by the "substantial continuity" test used in other contexts where the government is seeking to impose successor liability. It is determined by addressing whether the successor maintains the same business with the same employees doing the same jobs under the same supervisors, work conditions and production process, and produces the same product for the same customers. Not all factors are necessary.

On a purchase of assets which does not result in a "mere continuation" of the predecessor business, the buyer can request a Tax Clearance Certificate from Taxation and Revenue Department. That Certificate says that either (1) the old business owes no tax; or (2) the amount of tax due is $XXXXXX.

SUCCESSOR IN BUSINESS EXAMPLES: 7-1-61 7-1-63 NMSA

EXAMPLE 1:

7-1-61(C) and 7-1-63 - Purchase of assets of a pizza parlor by an unrelated party. Assets included kitchen equipment, tables and chairs, recipes, and current inventory. Leased premises – new lease executed by buyer. Buyer hired old staff – new W-4's, etc. Buyer executed its own contracts with same vendors.

Purchase price and fair value of assets is $50,000, which is paid directly to the seller with no tax clearance certificate. Outstanding GRT liability of seller business is $75,000.

7-1-63(B). The amount the buyer will be liable for as a successor in interest is the full value of the transferred tangible and intangible property unless the transfer was to evade tax, the new business is a **"mere continuation"** of the original business, or the successor assumed the tax liability.

Here, the Department can assess against buyer the entire $75,000, because the buyer's business is a "mere continuation" of the seller business. Total cost to buyer is $125,000.

EXAMPLE 2:

Seller of same pizza parlor business sells the kitchen equipment only to a soup kitchen run by a local church. Value and sale price of $10,000 paid to seller.

Seller's GRT liability was $75,000. Church did not get a tax clearance certificate, so a successor in business assessment of $10,000 would be allowed. This is not a "mere continuation" situation.

(Yes, there is a constitutional issue as to the state "assessing" a tax on a church. The state position is that it is not a tax against the church, it is in essence a "lien on the assets" situation, notwithstanding the assessment in the name of the church. Until it is litigated, this is what is working for the Department.)

Sterling Title Co. v. Commissioner of Revenue, 85 NM 279.

A title and abstract company which had been inactive for several months sold its remaining assets to a purchaser who incorporated the tangible and intangible property into the purchaser's business. Held that successor in interest assessment was valid because the business of the seller need not be an active or solvent business to be within the statute.

Determination of "successor" in business – Reg 3.1.10.16. List of 8 non-exclusive factors, **ANY ONE OF WHICH** creates a presumption of correctness and is sufficient to sustain an assessment. Factors are argued on protest, hearing, court case. Relevant factors include sale of major part of a business; transfer not in ordinary course of seller's business; substantial part of both equipment and inventories transferred; did goodwill follow transfer (same customers, name recognition, etc.); were contracts or uncompleted sales or orders transferred.

Take-aways:

The old "buy assets and not the business" to avoid acceptance of liabilities doesn't work in successor-in-interest situations as far as outstanding GRT is concerned.

The state successor-in-interest provisions for following assets into the hands of the buyer are much broader than the transferee liability provisions, and much easier to prove. Don't try to apply the narrower transferee liability provisions or try to draft around it. A specific provision in a purchase agreement saying that "no liabilities are assumed" or even "no tax liabilities are assumed" or assets transfer "free of tax liabilities" is useless.

NEW MEXICO STATE ADMINISTRATIVE PROCEDURES:

- GRT administrative procedures are contained in Sec. 7-1-1 et seq., the general administrative provisions for tax administration.

- Gross receipts tax liability issues may arise in the context of a field audit or in the context of a "Limited Scope Audit".

- Limited Scope Audits are all generated by a mismatch of income reporting and gross receipts reporting, and the field audits by a matching program or random or program selection. The Department does a match of Schedule C income or 1099's against gross receipts reported and sends a notice of limited scope audit bringing the gross receipts number to the gross income number. It will assess additional tax on that basis if the taxpayer does not respond.

- The state has the **power to collect** by levy or otherwise any time after 90 days after a bill is issued and not paid, when the taxpayer becomes a "delinquent" taxpayer. It doesn't happen that quickly, but it can. There may or may not be a Final Notice Before Seizure issued. It isn't required.

- There are no due process appeals on collection.

- The state assesses before substantive protests or appeals are allowed. Collection is stayed if a substantive appeal is pending. Protest procedures are contained in Sec. 7-9-24.

- Tax Information Authorization. Fax to 841-6327 or to an individual agent if one has been assigned.

No Compromise of tax liabilities. The New Mexico Constitution bars any compromise of liabilities owed to the state. So, no tax or assessed interest is ever compromised. Compromises may be made on penalties, as those are subject to a "reasonable cause" type defense – a "no penalties should have been assessed" type argument.

Installment agreements: The state can enter into installment agreements for periods up to 72 months, by statute. The agreement has to include all the liabilities. There are no partial payment agreements, since that would be an unconstitutional compromise. To get an installment agreement with the state, you have to stipulate to liability for the entire amount.

This is a problem. In a pinch, where you can show that the taxpayer can only pay so much a month, you can talk them into 71 equal payments with the balance as the 72nd , and then enter into another agreement after the 72nd payment isn't made. They don't like this, but will do it to get the case closed.

Injunction: The state can and will get an injunction against a taxpayer who continues to accrue gross receipts tax liability. E.g., Gardunos, WisePies. A delinquent taxpayer is defined as one who didn't pay within 90 days of the first demand and who has been issued a letter requesting the posting of bond and didn't post.

The decision as to whether to file for an injunction is made by the Department on an ad hoc basis. There is no right to an installment agreement in lieu of injunction action, although many threatened injunction actions are resolved with a payment plan.

Restaurants, etc. Liquor licenses are renewable each July 1. A license cannot be renewed, by law, if there are any gross receipts tax, penalty and interest outstanding for the sale of liquor. In practice, the license will be renewed if an installment agreement is in place by the date of

renewal. This applies across entity lines – if the license is owned by one entity and leased to a restaurant or bar, it is the gross receipts tax of the lessee that is tested.

Uncollectible status: For gross receipts tax, there is no Temporary Hardship Status if the business continues to operate.

Managed audits:

The state has a quasi-amnesty program called the Managed Audit program for non-filers or taxpayers who need to amend returns and increase tax due. The program is available to gross receipts tax liabilities and any other tax administered by TRD. If the procedure is followed, a taxpayer can file a late return or an amended return, and if the tax is paid within 180 days of assessment, all interest and penalties are waived. There are limitations.

Collection of GRT liabilities from spouse of operator of business:

New Mexico community debt law classifies gross receipts tax debt as a community debt if it was incurred during marriage. Gross receipts tax liabilities incurred from the operation of a business during marriage are **community debts regardless** of which spouse owns and operates the business, and regardless of whether the business itself is separate or community property.

Community debt can be collected from either spouse, from community or from separate property of either spouse.

There is a limited exception recognized by the state as to collection of delinquent gross receipts tax from the spouse who did not operate the business. Sec. 7-1-17.1. That section provides that the Secretary may determine that it would be "inequitable" to collect the business tax debt from the spouse or former spouse of the operator of the business, and if so, may "decline to bring an action or proceeding to collect such taxes against the spouse or former spouse".

Guidelines for making the determination of inequity are to be made by Regulation. The regulations provide that in the case of a community debt from the operation of a business, the factors to be considered include whether or not the spouse participated in eh conduct of the business, whether the spouse benefitted from the business, knowledge or lack of knowledge that the spouse had a business, whether the spouse had knowledge of the tax liability when it arose, and whether or not the Department could collect from the spouse who operated the business. Regs. Sec. 3.1.12.13.

NOTES

Wage Classifications: Laws Governing Minimum Wage, Overtime and Independent Contractor Status

EMPLOYEE VS. INDEPENDENT CONTRACTOR & CONSEQUENCES OF MISCLASSIFICATION

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OVERVIEW

- The business and worker relationship must be examined for federal employment tax, US Department of Labor and New Mexico law purposes
- **Independent Contactor** if payor has a right to control or direct only the result of the work – independence of worker
- **Employee** if payor can control what work will be done and how it will be done – degree of control over worker

IRS EVIDENCE OF DEGREE OF CONTROL OR INDEPENDENCE TO DETERMINE PROPER CLASSIFICATION OF A WORKER

- Behavioral
- Financial
- Type of Relationship

BEHAVIORAL CONTROL

- Worker is an employee when business has a *right* to direct and control worker's behavior
- Behavioral Control Factors
- I) Type of instruction given
- II) Degree of instruction
- III) Evaluation Systems
- IV) Training

FINANCIAL CONTROL

- Significant investment
- Unreimbursed expenses
- Opportunity for profit or loss
- Services available to the market
- Method of payment

RELATIONSHIP BETWEEN THE PARTIES

- Written contracts
- Employee benefits
- Permanency of the relationship
- Services provided as key activity of the business

US DEPARTMENT OF LABOR SIX FACTOR TEST

- Is work performed an integral part of the employer's business.
- Whether the worker's managerial skills affect opportunity for profit and loss.
- The relative investments in facilities and equipment by the worker.
- The worker's skill and initiative.
- The permanency of the worker's relationship.
- The nature and degree of control in the working relationship.

NEW MEXICO "ABC TEST"

- To determine if a worker is an independent contractor:

A. Is worker free from control or direction in performing services;

B. Are the services outside the usual course of business or are the services performed outside of all the places of business of the enterprise; and

C. Is the worker customarily engaged in an independently established trade, occupation, profession or business.

- New Mexico also uses the US Department of Labor's Six Factor Test

CONSEQUENCES OF MISCLASSIFICATION

- Business may be liable for employment taxes (Social Security, Medicare taxes and Unemployment tax)
- Worker can file IRS form entitled Uncollected SS and Medicare Tax or Wages – Form 8919
- The DOL possible exposure – minimum wage, hour and overtime pay violations
- NM "ABC Test" possible exposure – a misclassification could cause employee to be eligible for unemployment
- Independent Contractor may be liable for gross receipts tax for services provided

REFERENCES AND DISCLAIMER

- https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation
- https://www.irs.gov/businesses/small-businesses-self-employed/financial-control
- https://www.irs.gov/businesses/small-businesses-self-employed/behavioral-control
- 29 U.S.C. § 203(e) and 207(a)
- N.M. Stat. Ann. § 51-1-42(F)(5)
- The information in this PowerPoint is not intended as legal advice applicable to a specific situation or general category of employment arrangements. Employers should consult with counsel to ensure they are in conformity with applicable laws.

QUESTIONS

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Estate Planning Strategies for Business Owners

ESTATE PLANNING STRATEGIES FOR BUSINESS OWNERS

I. **New Tax Act Increases the Estate and Gift Tax Exemptions.** The **Tax Cut and Jobs Act of 2017** increased the federal estate tax and gift tax exemption to $11,180,000 for people who die or make large gifts in 2018. That is roughly twice the 2017 exemption of $5,490,000. The exemption covers taxable gifts made during lifetime and a person's remaining assets at death. The dollar amount of the exemption will continue to increase each year based on the rate of inflation.

The new Estate and gift tax Exemption is only temporary. The $11,180,000 will automatically expire and revert back to the $5,490,000 exemption level (adjusted for inflation) on January 1, 2026 if Congress does not pass new legislation to extend it. Also, the Exemption could be lowered before that date if a future Congress decides $11,180,000 is too much.

A person dying in 2018 who has more than $11,180,000 in assets will be charged an Estate tax of 40% on the value of all assets in excess of the exemption. For example, the Estate of a person with $12,180,000 in assets will be required to pay an Estate tax on the $1,000,000 in assets that are in excess of his or her $11,180,000 Exemption. The Estate tax will be 40% x $1,000,000 = $400,000.

II. **Should I change my Estate Plan due to the higher Exemption?** The answer to this question is "it depends". It depends on how wealthy you are, whether you or your spouse have children from a prior marriage and whether you believe a future Congress may lower the estate tax exemption to a level that would cause your family to owe an estate tax.

Obviously, the larger Estate Tax Exemption will mean that most of us do not have to worry about owing an Estate Tax when we die, if the larger exemption is still in place when we die. That means we may not need some of the special tax savings provisions in our current Revocable Trust Agreement or Will. This is a good time to review your estate plan to determine if any of the following options would work better for your plan.

A. **Option 1 - Switch to a "Simple Revocable Trust".** If you currently have an A-B Trust or an A-B-C Trust (designed to save estate taxes for a married couple), a simple Revocable Trust might be a better option. A simple Revocable Trust is one that does not split into two or three separate Trusts when the first spouse dies, as do the A-B and A-B-C Trusts. The simple Revocable Trust just continues as one Trust for the surviving spouse with total access to 100% of the Trust's assets. No restrictions, no complications, no problem!

The simple Revocable Trust is a good strategy for married couples with less than $3,500,000 for sure and may be good for couple's with up to $5,000,000 or more in total assets. At those asset levels couples are not likely to owe an estate tax even if Congress lowers the exemption in the future. However, the closer a couple's net worth

gets to $3,500,000, the more risk they run that a future Congress will lower the Estate Tax Exemption to a number that causes them to owe an Estate Tax at death.

A simple Revocable Trust may not be suited for some couples, even if they do not have a lot of assets. For second marriage couples who have children from their first marriages a simple Trust might not be the right plan. A simple Trust would allow the surviving spouse to change the beneficiaries of the Trust. That means he or she could leave 100% of the Trust's assets to his or her children (and disinheriting the deceased spouse's children).

The simple Trust is also not well suited for couples who Trust want to provide liability protection for the surviving spouse. The assets of a simple are 100% available for the surviving spouse's creditors to attach. The simple Trust also does not provide any protection against a future new spouse of the surviving spouse.

B. <u>Option 2 – Keep you're A-B Revocable Trust</u>. If you have assets of $5,000,000 you should consider keeping (or using) an A-B Trust for your estate plan. There are other options discussed later in this Newsletter that may work better for your family, but keeping your A-B Trust is certainly one option to consider. If you do want to keep you're A-B Trust, we recommend you review it carefully to make sure its terms will be "user friendly" for the surviving spouse, as explained below.

Many of the A-B Trusts we have seen contain restrictions on the surviving spouse's right to use money or other assets held in the deceased spouse's Trust B. In fact, many prohibit the surviving spouse from using any of the principal of Trust B until the assets held in his or her Trust A have been consumed. The restrictions may be appropriate for second marriage couples where they are trying to preserve Trust B's assets for the deceased spouse's children. However, for many couples these restrictions are unnecessary and should be eliminated. Your Trust Agreement can be amended to make the assets of Trust B readily available for the surviving spouse without sacrificing the creditor protection and tax savings provided by Trust B.

There are some problems associated with using an A-B Trust for your estate plan. The A-B Trust requires a significant amount of legal work and expense after the death of the first spouse. The Trustee of the Trust is required to divide the couple's Revocable Trust into two (2) separate Trusts, Trust A to hold the surviving spouse's share of the Trust's assets and Trust B to hold the deceased spouse's share. After the assets have been divided between the two Trusts, Trust B has to file a separate federal and State income tax return each year.

Perhaps the biggest problem with using Trust B is its assets will not receive a "step-up in basis" when the surviving spouse dies. The step-up in basis is an income tax break the people who inherit a person's assets. The person inheriting a deceased person's assets is treated as having purchased the assets at their full fair market value on the date of death. When the inheritor sells the assets there is no capital gain tax to pay. If the inheritor sells the assets for more than the date of death value sometime later, the capital gain tax only applies to the increase in value that occurred after the

assets were inherited. The step-up in basis applies to inherited assets even if there is no estate tax due on those assets.

The step-up in basis is a huge tax break for inherited assets, but it is only available if the assets belong to the deceased person or are taxable as part of the deceased person's estate. Trust B is designed so that its assets do not belong to the surviving spouse and are not taxable as part of the surviving spouse's estate when he or she dies. So, Trust B's assets are not eligible for the step-up in basis when the surviving spouse dies.

C. **Option 3 – Use an A-B (Qtip) Trust to added flexibility.** A plan that incorporates the creditor protection and inheritance protection features of the traditional A-B Trust, but also provides an opportunity to qualify Trust B's assets for the step-up in basis tax break is an A-B (Qtip) Trust. The A-B (Qtip) Trust allows the surviving spouse (or other Successor Trustee) to elect to have Trust B function like a traditional Trust B, in order to save estate taxes, or to turn Trust B into a "marital Trust" that qualifies for the step-up in basis when the surviving spouse dies.

The Trustee of the Revocable Trust has nine (9) months after the first spouse dies to make the election to turn Trust B into a marital Trust for the surviving spouse. The Trustee can even file for a six (6) month extension of the deadline to make his or her decision, which gives the Trustee up to fifteen (15) months to make his or her final decision. This allows the Trustee to determine the exact value of the couple's estate, how fast their assets are likely to appreciate in the future and the likelihood the surviving spouse may live for a long time. The Trustee can even consider whether it is likely that Congress is going to lower the estate tax exemption before the surviving spouse dies.

The ability to delay the final decision about which estate planning option works best for the couple's family for up to fifteen (15) months after the first spouse dies is a huge advantage over the couple having to choose an option today. Using a traditional A-B Trust plan requires the couple to lock in an estate plan that may not be the best plan when one of the dies. The A-B (Qtip) Trust option makes it much more likely the plan chosen after the first spouse dies will be a better fit for the couple's needs, whether that is to save estate taxes or to secure a second step-up in basis of Trust B's assets.

III. Annual Nontaxable Gift Limit Increased. The annual gift tax exclusion for 2018 was also increased to $15,000 per person, per year. This means you can gift money or assets worth up to $15,000 to as many different people as you like without you or the gift recipient having to pay any gift tax. Gifts up to $15,000 to any person are completely "tax free" and the gifts will not be deducted from your lifetime estate and gift tax exemption of $11,180,000.

So, in light of the increase in the estate tax exemption does it make sense to make annual gifts to take advantage of the new tax free gift limit? Well, unless your total assets are in excess of $11,000,000 for a single individual or $22,000,000 for married couples, you do not need to make annual tax free gifts to save estate taxes. However, there may be other good, nontax reasons to make annual gifts to family members or others.

Many people make annual gifts because they want to help members of their family now, rather than waiting until they die. That makes sense and the new $15,000 nontaxable gift tax limit means they can give more to help loved ones without having to worry about paying a gift tax. Even if a gift exceeding the $15,000 gift limit is made to one individual, there still will not be any gift tax due from the person making the gift or the person receiving the gift currently. All that will happen is the person making the gift will file a Federal Gift Tax Return on Form 709 to report the excess gift amount, which will be subtracted from the givers' $11,180,000 gift tax exemption. In most cases this is no big deal and will not cause the giver's estate to owe an estate tax when they die. As long as the giver has enough estate tax exemption left to cover the value of his or her assets at death, there will be no estate tax due.

IV. Step-up in Income Tax Basis at Death. The biggest tax break available to people who will not owe an estate tax is the IRS rule that eliminates all income tax on capital gains on highly appreciated assets. **Section 1014(a) of the Internal Revenue Code ("IRC")** states that the income tax basis of property inherited from a deceased person (hereafter referred to as the "decedent") is the fair market value of the property on the date of death. This process of revaluing assets at death is commonly referred to as a "step-up in basis" by accountants and tax lawyers, so I will use that terminology for the remainder of this letter. There are different step-up in basis rules for different types of assets, such as separate property owned by a married couple, community property owned by a married couple, jointly owned property owned by a married couple, jointly owned property by people who are not married, and property on which depreciation was allowed as an income tax deduction. The remainder of this part of the Outline explains how these rules work in each of these situations.

A. Example of the Step-up in Basis Rule. A business owner paid $100,000 for 100% of the stock of the Company when he bought it in 1990. The business is worth $2,000,000 when the business owner died on July 31, 2018. The Inheritor (surviving spouse, child or Revocable Trust) is treated as having paid $2,000,000 to purchase the business owner's stock.

B. Reason for Stepped-Up Basis. The reason the tax laws allow a step-up in basis on inherited assets is to avoid over-taxing the decedent's assets by subjecting them to the estate tax and a capital gains income tax when the assets are eventually sold. At one time, the combined maximum estate tax rates and income tax rates would have exceeded 100% of a property's value. Therefore, Congress enacted the step-up in basis rules to eliminate the capital gain income tax on most inherited assets which means those assets will only be subject to the estate tax. The good news for all of us is that we get the benefit of the step-up in basis for income tax purposes even if the deceased person did not have a taxable estate and did not have to pay any estate taxes. For this reason, the step-up in basis rules are always important on every estate, regardless of the size of the estate.

C. Separate Property. If the decedent owned the entire asset as separate property the beneficiary gets a stepped-up basis on the entire property.

D. **Jointly Owned Assets.** There are special rules that apply to assets that are held jointly between the deceased person and at least one other person. The stepped-up basis rules applicable to jointly owned property will depend upon whether the property is owned as "tenants-in-common" or as "joint tenants" (including property owned by a married couple as "tenants by the entirety"). For married couples, the application of the stepped-up basis rules will also depend upon whether joint tenancy property is "community property" under the law of the state where the property is located.

E. **Tenants-in-Common Assets.** Any assets held in the name of the deceased person and one or more other person(s) as "tenants-in-common" will result in a step-up in basis on only the share of the asset owned by the deceased person. For example, if the deceased person owns one-half (1/2) of the tenants-in-common asset, only one-half (1/2) of the asset's value is included in the deceased person's estate. For this reason, the person that inherits the deceased person's one-half (1/2) interest gets a step-up in basis on that one-half (1/2) inherited interest, but the joint owner does not get any step-up in basis on his or her share that they already owned. **ITR 1.1014-2.**

F. **Joint Tenancy and Tenancy by the Entirety Assets.** Assets held by the deceased person and one or more other person as "joint tenants," or by a married couple as "tenants by the entirety," will result in the entire property being revalued for income tax purposes. The stepped-up basis rules apply to the entire property because **IRC Section 2040** requires the decedent's estate to report the entire value of the property as though it was entirely owned by the decedent. The only exception to this rule is where the other joint tenant(s) can prove that he or she did not acquire the joint tenancy interest from the decedent. **IRC Section 2040(a).**

If the joint tenancy interest was acquired from the decedent, the estate can only exclude the part of the joint tenancy property that is in proportion to the amount paid by the surviving joint tenant for his or her share of the asset. Therefore, the calculation of the stepped-up basis for joint tenancy property will depend upon whether the entire value of the joint tenancy property is required to be reported by the estate or whether the estate was allowed to exclude a portion of the value of the property because the joint tenancy interest was not acquired from the decedent, or the other joint tenant is able to prove that he or she paid for that interest.

Except for joint tenancy assets held by a married couple as community property, the stepped-up basis only applies to the part of the joint tenancy property required to be reported by the estate. The surviving joint tenant's original cost basis applies to his or her share that is not required to be reported by the estate. In most cases, the surviving joint tenant received his or her share as a gift from the deceased person, so the entire value of the joint tenancy property is required to be reported for estate tax purposes and the entire property receives a stepped-up basis for income tax purposes.

G. **Applying Depreciation Rules to Inherited Property.** There is a huge tax benefit available to you or the other heirs of the decedent if any of the assets or property inherited qualifies for the depreciation deduction for income tax purposes. The

stepped-up basis rules allow the property to be depreciated based upon the new fair market value stepped-up basis, rather than the old historical cost of the property. This is true even though the property may have already been fully depreciated by the deceased person. **IRC Section 1014(b)(9)** and **ITR 1.1014-6(a)(1)**. Sometimes people, including attorneys and accountants, are not familiar with this rule and they do not take advantage of the significant income tax savings that are available by claiming the new depreciation deduction. For this reason, I have included a detailed explanation of how the depreciation rules work and when the depreciation deductions previously allowed on the property must be considered in calculating the new stepped-up basis for the property.

H. **Depreciation Allowable in Prior Years**. The depreciation deductions "allowed or allowable" to the deceased person in prior tax years are completely ignored. You do not have to account for the decedent's prior depreciation deduction and you do not have to subtract them from the fair market value of the property to determine the stepped-up basis. However, any depreciation deductions allowed in prior years to the person who is inheriting the deceased person's depreciable property must be subtracted from the fair market value of the property in order to determine the stepped-up basis for income tax purposes. **IRC 1014(b)(9)**. The stepped-up basis determined under this procedure can then be depreciated by the heir who is considered to be the new owner of the property. The new owner must depreciate the property over the useful life of the property starting on the day after the date of death of the decedent. This special rule is applicable to married couples who file joint income tax returns and can be illustrated by the following example:

1. **Example**. The wife owns an apartment building, as her separate property, on which depreciation is allowed as a deductible expense for income tax purposes. She and her husband file a joint income tax return each year and claim a depreciation deduction on the apartment building. The wife dies and leaves the apartment building to her husband.

2. **Question**. Is the husband required to subtract his share of depreciation deductions from the date of death value of the apartment building in determining the stepped-up basis?

3. **Answer #1**. If the couple lives in Colorado, the answer is "yes", because under Colorado law both spouses are entitled to one-half (1/2) of the income from the wife's (or husband's) separate property.

4. **Answer #2**. However, if the couple lives in New Mexico, the answer would be "no", because all income from the separate property belongs to the spouse who owns the separate property.

I. **Depreciation Allowed in Year of Death**. The depreciation deduction allowed on the deceased taxpayer's final tax return (whether a joint tax return or separate tax return), for the time up through the Decedent's date of death will be based upon the historical cost of the property, and will not be calculated using the step-up in basis that occurs at death. The basis for depreciation for the remainder of the year

following the date of the decedent's death is based upon the stepped-up basis rules described above. Again, the decedent's share of depreciation allowed prior to the date of death is ignored and only the depreciation allowed to the other spouse, or other owner, prior to the decedent's death is taken into consideration in calculating the new stepped-up basis.

The depreciation rules for calculating the stepped-up basis are contained in **ITR Section 1.1014-6.** This section of the regulations explains the rules I have outlined above in greater detail and gives examples that may be helpful to your accountant in calculating the depreciation to which you and the other heirs of the estate will be entitled in the future.

J. Step-down in Basis. Although I have made a big deal in this letter of the benefits of the stepped-up basis rules, I must point out that these rules can require a reduction or "step-down" in basis if the property is worth less than its historical cost on the date of death. In other words, these rules work both ways. The rules will give the step-up in basis where the property is worth more on the date of death than its historical cost basis (less depreciation) and will require a step-down in basis where the property is worth less on the date of death than its historical cost basis. For this reason, it is advisable for a person to sell assets that have decreased in value (such as shares of stock) prior to death so that a capital loss deduction can be claimed on his or her income tax return. Since shares of stock that have decreased in value from when they were originally purchased will require a step-down in basis, the heirs will not be able to take advantage of the capital loss deduction.

K. Assets Not Available for Stepped-up Basis. Although it is hard to explain logically, some assets includable in a deceased person's Estate are not eligible for the step-up in basis. These assets are called "income in respect of a decedent" ("IRD") and consist of assets such as IRAs, pension and profit sharing plans, 401(K) plans, installment sales contracts and annuities. Each of these types of assets represent income to which the deceased person was entitled prior to the date of death, but which has not been reported for income tax purposes because they were not collected before the person died. For example, an IRA account does not receive a step-up in basis at the time of the decedent's death, because the balance in the IRA account on the date of the decedent's death has never been subject to an income tax. Most inherited IRAs will have an income tax basis of zero for the heirs, which means the heirs will report 100% of what they withdraw from the IRA as income at the time the withdrawals are made.

The way the IRD rules work is the heirs get the decedent's tax basis for the IRD asset. For example, if the decedent sold property under a real estate contract ("REC") and reported the sale under the installment method on his or her income tax returns, then the heirs get the taxpayer's basis in the REC. This means the heirs will report the same amount of capital gain income and interest income that the decedent would have reported if he or she were still alive. The payments are reported as they are collected by the heirs and reported on their own tax return. The heirs use the decedent's old basis in the REC to determine what part of the payments are to be treated as interest, capital gain, ordinary income, or the nontaxable return of capital. The reporting of

annuities is similar to the REC example. Each payment received from an annuity by the decedent's heirs will usually include some part of the payment that is the return of capital (the decedent's original amount paid for the annuity) and another part that is the income earned on the annuity. The income part is taxable, but the part that represents a return of capital is not taxable. As long as your accountant has all of the correct information, he or she will be able to correctly determine the part of an annuity payment that is taxable.

L. Assets Inherited Through a Revocable Trust. Assets inherited from a Revocable Trust are considered to be owned by the Grantor of the Trust and, therefore, qualify for the step-up in basis. Likewise, assets inherited by a beneficiary of the Revocable Trust are treated as having been inherited directly from the Grantor. So, the beneficiary is entitled to the step-up in basis on any assets he or she receives from the Revocable Trust based on the asset value on the date of the Grantor's death.

When married couple's use an A-B Revocable Trust for their estate plan the surviving Grantor's share of the Trust's assets are allocated to Trust A and the deceased Grantor's assets are allocated to Trust B. Trust A's assets will be includible in the surviving Grantor's Estate for estate tax purposes when the survivor dies, so there will be a second step-up in basis for Trust A's assets. Trust B's assets do not get a second step-up in basis when the surviving Grantor dies. Why? Because, Trust B's assets are not includible in the surviving Grantor's Estate when he or she dies, so Trust B's assets do not meet the requirements of **IRC Section 1014(a).**

M. Switching to an A-B (Qtip) Trust qualifies Trust B for a Second Step-up in Basis. Couples who currently have an A-B Revocable Trust estate plan should give serious consideration to switching their Trust Agreement to an A-B (Qtip) Revocable Trust model. This will make Trust B's assets automatically includible in the surviving Grantor's Estate for estate tax purposes (unless an Estate Tax Return Form 706 is filed to elect to have Trust B included as part of the deceased Grantor's Estate when the first Grantor passes away.

The inclusion of Trust B's assets in the surviving Grantor's Estate at death results in a second step-up in basis under **IRC Section 1014**. The decision whether to elect out of Qtip treatment when the first Grantor dies can be made for up to 15 months after the first Grantor died. This gives the surviving Grantor and the Executor of the Estate a tremendous opportunity to do some effective estate tax/income tax planning at a time when the value of the Estate's assets, the amount of the estate tax exemption and the health of the surviving Grantor are all known.

With a traditional A-B Revocable Trust, the couple has picked their tax strategy (to save estate tax and to forego saving capital gains tax) on the day they signed their Revocable Trust Agreement. Some couple's sign their Revocable Trust Agreement as much as 20 years prior to the date of death of the first Grantor to die. Based on these facts, the A-B (Qtip) Revocable Trust Agreement gives a married couple a tremendous advantage over the use of a traditional A-B Trust Agreement.

V. Trust ownership of S Corporation Stock. Under the S Corporation tax rules contained in **IRC Section 1361**, there are only three (3) types of Trusts that qualify to own S Corporation stock, a Grantor Trust, a Qualified Subchapter S Trust ("QSST") and an Electing Small Business Trust ("ESBT"). If a non-qualifying Trust owns S Corporation shares the penalty is to terminate the Corporation's S Election, which turns the Corporation into a tax paying C Corporation.

As you know, the tax rules for a C Corporation subject the profits of the business to double taxation, once when the Corporation earns the profit and a second time when the profits are distributed to the Shareholders. Even though the tax rates for a Corporation's earnings have been lowered significantly, this is still a bad result for most Corporations and their Shareholders.

Since Trusts are an important of many business owners' estate plans and many of their businesses are S Corporations, it is important for us, as business lawyers, to assure that any Trust that becomes a Shareholder is a Grantor Trust, a QSST Trust or an ESBT Trust. The IRS requirements for a Trust to be a Grantor Trust, a QSST Trust or an ESBT Trust are listed below.

A. Grantor Trusts. In estate planning, the person who creates a Trust is called the "Grantor", "Trustor" or "Settlor". These three terms all mean the same thing. The assets contributed to the Trust normally come exclusively from the creator of the Trust. So for most Trusts the person who creates the Trust is also the person who contributes the assets to the Trust. While every Trust has at least one "Grantor", not every Trust is a "Grantor Trust" under the IRS rules.

A "Grantor Trust" is a Trust over which the Grantor has too much control for the IRS to agree the Trust should be taxed as a separate entity. **Sections 671 – 678 of the Internal Revenue Code** set out the rules for determining when the Grantor of the Trust (or someone else) will be treated as still being the owner of part or all of the Trust's assets for Income Tax purposes. The Grantor Trust rules **IRC Sections 671 – 678** are only Income Tax rules and they do not determine whether a Trust belongs to the Grantor for Estate and Gift Tax purposes.

The most common type of Grantor Trust is a Revocable Trust, also called a Living Trust. **IRC Section 676** says that a Trust that the Grantor has the power to revoke is a Grantor Trust. That means the Grantor is treated as still owning the assets of the Trust for Income Tax purposes. The Grantor is required to continue reporting any income and capital gains on the Grantor's personal income tax return. The IRS does not want Grantors who own a Revocable Trust to file an income tax return for the Trust or to secure a separate Federal Identification Number for the Trust. The Grantor uses his or her Social Security Number as the Federal Identification Number for the Trust.

B. Qualified S Corporation Trusts ("QSSTs"). A QSST is a Trust that meets all of the following requirements of **IRC Section 1361(d)(3)** will be treated as a qualified Shareholder that can own S Corporation stock.

1. **Only One Beneficiary Allowed.** During the term of the current income beneficiary's lifetime there is only one (1) beneficiary of the Trust.

2. **No Principal Distributions to anyone but the Current Income Beneficiary.** Any Trust principal ("corpus") distributed during the lifetime of the current income beneficiary must be distributed to that beneficiary.

3. **Income Interest Terminates at Death or Trust Termination.** The income interest of the current income beneficiary in the Trust shall terminate on the earlier of such beneficiary's death or the termination of the Trust.

4. **All Assets Distributed to Beneficiary if Trust Terminates during Beneficiary's Lifetime.** Upon the termination of the Trust during the life of the current income beneficiary, the Trust shall distribute all of its assets to such beneficiary.

5. **All Trust Income is Distributed Currently.** All of the Trust income (within the meaning of **IRC Section 643(b)**) must be distributed currently to one (1) individual who is a US Citizen or US resident.

6. **QSST Election is made by the Beneficiary.** To qualify the Trust as a QSST, the **beneficiary** of the Trust (or the beneficiary's legal representative) must make the election under **IRC Section 1361(d)(2)**. The beneficiary must file the QSST Election within "two months and 15 days" following the receipt of the S Corporation shares.

7. **QSST Election Requirements.** The following requirements must be met for a beneficiary to effectively elect to have the Trust qualify as a QSST:

(a). Separate Election for Each S Corporation. A separate election must be filed for each S Corporation in which the Trust owns shares.

(b). Election remains effective for successive beneficiaries. The QSST Election remains in effect for each successive beneficiary, unless such beneficiary affirmatively refuses to consent to such Election. The Election is "irrevocable" by a beneficiary once it is made, unless the Secretary of the Treasury agrees to the revocation.

(c). Election Requirements governed by IRS Regulations. The QSST Election under **IRC Section 1361(d)(2)** must meet all the requirements of **Treasury Regulation Section 1.1361-1(J)(6)(ii)(E)(1), (2), and (3)**.

(d). Due Date for Election. The QSST Election is required to be filed within the Two (2) months and Sixteen (16) days period beginning on the first date S Corporation stock is owned by the Trust. **Note** - The filing deadline is based on Calendar months, so the time for making the Election will depend on what months of the year are involved.

C. Electing Small Business Trust ("ESBT"). An ESBT Trust is used when S Corporation shares are going to be owned by a Trust that has multiple current

beneficiaries. An ESBT pays the income tax on all S Corporation income, including any capital gains. The ESBT S Corporation earnings **are taxed at the highest individual tax rates for ordinary income items and at the highest capital gains tax rate on all capital gains**.

The ESBT's other income (not received from an S Corporation) is taxed under the normal Trust tax rules. Under the normal Trust tax rules any income retained by the Trust is taxed to the Trust and any income distributed to the beneficiary is taxed to the beneficiary. A Trust has 65 days following the end of its tax year (normally December 31st) to make distributions to its beneficiaries and still treat the distribution as coming from the prior year's income.

An ESBT must meet the following requirements contained in **IRC Section 1361** and **Treasury Regulation 1.1361-1(m)**:

1. **No Disqualifying Beneficiaries Allowed.** The Trust may not have any beneficiaries other than an individual, an Estate, a Charitable Organization described in **IRC Section 170(c)(2) though (5)**, or a Charitable Organization described in **IRC Section 170(c)(1)** that holds a contingent interest in the Trust and is not eligible to receive current distributions of Trust income.

2. **Trust cannot acquire Stock by Purchase.** If the S Corporation stock is purchased by the Trust, the Trust does not qualify to make the ESBT Election.

3. **The Trust may not be an Ineligible Trust.** QSST Trusts, Trusts that are tax-exempt under the Charitable Organization rules and Charitable Remainder Trusts (both kinds) do not qualify to make the ESBT Election.

4. **ESBT Election is made by the Trustee.** An Election to have the Trust treated as an ESBT must be made by the **Trustee** of the Trust. The requirements for the Election Statement to be filed with the IRS are similar to those for a QSST Election and are contained in **Treasury Regulation 1.1361-1(m)(2)**.

D. **Intentionally Defective Grantor Irrevocable Trusts ("IDGITs").**

Occasionally, you will encounter an Estate Plan where the Grantor has set up an **Irrevocable Trust** for his or her children, but where special provisions have been added to the Trust Agreement to make the Trust a **"Grantor Trust"** for income tax purposes, but to not make the Trust's assets includible in the Grantor's Estate for Estate or Gift Tax purposes. This type of Trust is called an "Intentionally Defective Grantor Irrevocable Trust" or **"IDGIT"**.

IDGITs are typically used in rather large Estates where a business owner has a very valuable Corporation that is an S Corporation. The provision most estate planning lawyers add to the Irrevocable Trust Agreement to make the Trust a Grantor Trust is **"the power to reacquire the trust corpus by substituting other property of equivalent value"**. **IRC Section 675(4)(C)** provides that a Grantor retaining this power makes the Grantor the owner of the Trust's assets for income tax purposes. However, this power does not make the Grantor the owner of the Trust's assets for Estate or Gift Tax purposes.

Since the **IDGIT** is a Grantor Trust, the Grantor is **required** to report and pay the income tax on all of the Trust's income each year. This is true even though the Grantor would not have the right to receive any part of the income (in a properly drafted **IDGIT**).

Why on earth would a business owner ever want to have to pay income tax on money he or she will never receive? Because it allows the business owner to pay the income tax out of his or her own money (reducing the Grantor's Estate), which allows the Trust for the Grantor's kids to keep all of its income, which means there is more money for the kids to receive. The IRS has ruled that a Grantor paying the income tax on the **IDGIT's** income is not a taxable gift to the beneficiaries of the Trust. That is incredible! Because the net effect of the Grantor paying the income tax on the Trust's income is to make an additional gift to the Trust in the amount of the income tax the Grantor is paying to the IRS and State. Using this technique reduces the Grantor's Estate Tax by depleting the value of the Estate (paying the taxes) and increasing the gifts to the Grantor's children by allowing the Trust to not have to pay any income tax on its income.

S Corporation Stock is a common gift to an **IDGIT**. Since the **IDGIT** is a Grantor Trust for Income Tax purposes, the stock of the Trust is treated as still belonging to the Grantor, so the Trust is automatically a qualified S Corporation Shareholder and no special election of tax forms are required to be filed on behalf of the Trust or its beneficiaries.

V. Use of an Irrevocable Trust for a Business Buy-Sell Agreement. The "Trusteed Buy-Sell Agreement" is something business owners may want to consider to assure that the terms of the Corporation's Shareholders Agreement or Buy-Sell Agreement are actually carried out when a business owner dies.

A. Income Tax Advantages of a Cross-Purchase Agreement. There is a significant income tax advantage to using a Cross-Purchase Shareholders Agreement versus using a traditional Shareholders Agreement. A traditional Shareholders Agreement is one that obligates the Corporation to purchase a deceased Shareholder's shares. A Cross-Purchase Shareholders Agreement obligates the surviving Shareholders to purchase a deceased Shareholder's share.

The tax difference between the two methods is in the income tax basis the surviving Shareholders receive in the shares purchased of from the deceased Shareholder's Estate or Trust. If the Corporation buys the shares under a traditional Shareholders Agreement, the surviving Shareholders income tax basis in their shares does not change. In other words, the surviving Shareholders do not get any credit for their proportionate share of the purchase price. With a Cross-Purchase Agreement each surviving Shareholder receives an income tax basis equal to the purchase price in the shares he or she purchases. The Cross-Purchase Agreement approach gives each Shareholder 100% credit for the amount paid for the shares.

The difference between the two methods is huge if the surviving Shareholders ever sell their shares or the Corporation is liquidated. With a traditional Shareholders

Agreement the selling Shareholder has a zero basis in the shares bought from the deceased Shareholder's Estate. So, 100% of the sales proceeds is taxable.

The Cross-Purchase Agreement Shareholder only pays tax on the excess of the sales price over the amount paid for the deceased Shareholder's shares. The sale will result in the Shareholder only having to pay tax on the increase in value of the shares that has occurred since the death of the deceased Shareholder.

B. Potential Problems with Cross-Purchase Agreements. There are several potential problems that can arise when we use a Cross-Purchase Shareholders Agreement for the purchase of a deceased Shareholder's stock. The following is a list of some of the problems encountered with using a Cross-Purchase Agreement.

1. Surviving Spouse unhappy with Purchase Price. Surviving spouses are sometimes unhappy with the purchase price for the deceased spouse's part of the Corporation. If the surviving spouse does not like the price, he or she may refuse to sell the shares and litigation may be required to enforce the surviving Shareholders' right to buy the shares.

2. Surviving Shareholders want to keep the Life Insurance Proceeds. The surviving Shareholders may be tempted to keep the cash or may use the cash for other needs prior to the sale being consummated. In other words, it is the flip side of the problem identified in **paragraph A. 1** above.

3. Incapacity of a Survivor. A surviving spouse or a surviving Shareholder may be incapacitated or depressed or have other problems that make it difficult to carry out the terms of the stock purchase.

4. Multiple Owners results in Multiple Policies. A Cross-Purchase Agreement requires every Shareholder to own a policy on every other Shareholder. When there are more than two (2) Shareholders, this can become cumbersome. For example, if there are three (3) Shareholders there will be a total of six (6) policies to make the Cross-Purchase Agreement work.

C. Use of an "ILIT" can avoid the Cross-Purchase Agreement problems. If the Shareholders and the Corporation set up an Irrevocable Life Insurance Trust ("ILIT") to carry out the terms of the Cross-Purchase Agreement, it can eliminate many of the problems associated with individually managed Cross-Purchase Agreements.

1. Trust owns one Life Insurance Policy on each Shareholder.

2. Trust can also hold each Shareholder's shares (like an escrow agent).

3. Trustee collects the proceeds from a deceased Shareholder's policy.

4. Trustee distributes the purchase price to the deceased Shareholder's Revocable Trust or Estate.

5. Trustee distributes the deceased Shareholder's stock to the surviving Shareholders.

6. The Trustee, usually an independent third party, is only concerned with carrying out the terms of the Trust Agreement

D. Specialized ILIT Trust Agreement is required. The Trust Agreement used for the ILIT must be custom drafted to assure that none of the Shareholders have any "incidents of ownership" in their own life insurance policy. Additionally, there should be terms indemnifying the Trustee from liability associated with the purchase of the shares, valuation issues, etc.

If the IRS later determines that a deceased Shareholder had too much control or too many rights in his or her own policy the IRS could include the life insurance proceeds in the deceased Shareholder's Estate, which could result in an estate tax being due on the proceeds.

A single ILIT used to own all of the Life Insurance policies is not designed to do any "estate planning" for the individual Shareholders. It is more like an Escrow Agreement than a typical Life Insurance Trust in that respect.

E. Using Separate ILITs for a Cross-Purchase Agreement. If there are no more than two (2) or three (3) Shareholders involved, using a separate ILIT for each Shareholder can be advantageous. Each Shareholder would set up a fairly traditional ILIT that would include all of the normal estate planning terms for the Shareholder's intended beneficiaries (usually his or her children). So, the individual ILIT approach can accomplish the Shareholder's normal estate planning goals and also carry out the Shareholder's obligations under the Cross-Purchase Agreement.

1. Using the ILIT to save Estate Taxes. If the business owner is wealthy the individual ILIT can work wonders. If the business owner does not retain any rights under the Trust Agreement, neither the life insurance proceeds received on a deceased Shareholder's policy nor the stock purchased by the ILIT will be included in the surviving Shareholder's Estate when he or she dies.

2. Maintaining Voting Control. If the surviving Shareholders want to use individual ILITs, but want to maintain voting control of the Corporation, the Corporation (including an S Corporation) can set up Voting and Nonvoting shares. The Cross-Purchase Agreement can allow the surviving Shareholders the right/option to purchase the deceased Shareholder's Voting shares.

3. ILITs become parties to the Cross-Purchase Agreement. In addition to all of the Shareholders of the Corporation, each Shareholder's ILIT would become a party to the Cross-Purchase Agreement. Why? Because the Trust will be the will be owners of the Life Insurance policy on the other Shareholder and will be the purchaser of the deceased Shareholder's stock. So, the ILITs need to be parties to the Cross-Purchase Agreement.

F. **Avoiding the "Transfer for Value" problem under IRC Section 101.** Although life insurance proceeds are exempt from income tax. That rule does not apply to the purchase of an existing life insurance policy from another person or entity. If someone buys a $500,000 insurance policy from another person for $200,000, the purchaser is taxed on his or her $300,000 profit when the insured person dies.

The IRS has taken the position that using an ILIT (joint or individual) can result in triggering the "transfer for value rule" contained in **IRC Section 101**. The IRS's theory is that when one of the Shareholders in a joint ILIT dies, the other Shareholders gain a greater percentage ownership in the surviving Shareholders' policies, so it is like they are purchasing that increased interest. The IRS says that triggers the application of **Section 101** and that percentage of the future insurance proceeds received from the surviving Shareholder's policies will be taxable income.

The IRS has a similar argument on individual ILIT Cross-Purchase Trusts. Most Cross-Purchase Agreements provide that the surviving Shareholder's ILIT (or the surviving Shareholder) has the right to buy the remaining policy on the surviving Shareholder's life. The IRS says this is definitely a transfer for value transaction and the life insurance proceeds will be taxable income to the ILIT when the surviving Shareholder dies.

So, the transfer for value problem created by the IRS's interpretation of **Section 101** must be dealt with in order to avoid having to pay income tax on the life insurance proceeds.

G. **Eliminating the Section 101 Transfer for Value Problem. IRC Section 101**provides several exceptions to the "transfer for value rule" described above. While the exceptions are all important, the only one we need to focus on for this discussion is the exception for a "transfer to a partner". Under this exception, the transfer of a life insurance policy on the life of a partner of the transferee is an exempt transfer, even if money changes hands.

So, to avoid the transfer for value problem, we normally set up a Partnership between the Shareholders and all of their ILITs as part of the deal. The Partnership does not have to be related to the business of the Corporation. The Partnership does not have to be large. Most of the time it is funded with cash and the Partnership invests the money in a Certificate of Deposit or makes another investment. For example, the Partnership may receive a total of $30,000 and hold it in liquid investments. The Partnership files a federal tax return and the Partners report their shares of the profits or losses on their own income tax returns. The Cross-Purchase Agreement normally provides for the purchase of the deceased Partner's share of the Partnership, but it does not have to do so.

This totally eliminates the problem of the **IRC Section 101**transfer for value rule. It is an easy solution and it should be employed every time the Trusteed Cross-Purchase Agreement approach is going to be used.

VI. New Tax Law increases the Standard Deduction for Business owners. The new tax law increased the Standard Deduction for single business owners to $12,000 and $24,000 for married business owners. This means that unless your Itemized Deductions for the year exceeds these amounts, you will not receive any additional tax deduction from your charitable donations. Additionally, the new tax law limits the total amount of deductions from property taxes and State income taxes to a combined total of $10,000. Also, the Itemized Deduction for property tax paid on a second home has been eliminated. This means many of us will be using the new Standard Deduction, rather than our Itemized Deductions.

A. Consider making Charitable Gifts out of your IRA Account. The new tax law increasing the Standard Deduction for business owners provides a great income tax planning opportunity for people who are at least 70 1/2 years old who make annual gifts to charity. Business owners who are at least 70 1/2 years old are allowed to make charitable donations of up to $100,000 per year directly from their IRA. This law has been around for several years and has always been beneficial to older business owners who give to charity, but who may not have a lot of other Itemized Deductions. Now that the Standard Deduction has been increased significantly, it is more important than ever for older business owners to make their charitable gifts directly from an IRA.

The direct distribution from the IRA to a charity can be used to meet the IRA owner's "Required Minimum Distribution" or "RMD" for the year. The amount distributed is not included in the IRA owner's income for the year, so it does not get reported as income on the IRA owner's tax return. So, in essence, the IRA owner gets a 100% income tax deduction for the amount given.

Additionally, the IRA gift directly to the charity does not increase the donor's Adjusted Gross Income ("AGI") or the donor's Taxable Income for the year. Since the donor's AGI is used to determine the donor's Medicare Part B insurance premiums for the next tax year, the exclusion of the direct IRA gifts results in a lower insurance premium for the donor. A person's AGI also determines whether they qualify for many tax breaks and tax deductions that are available for people with lower AGIs. So, lowering your AGI by making direct charitable gifts from your IRA is a smart move to consider.

B. Gift of Highly Appreciated Stock or Other Assets. One of the best all-time gift techniques to consider for business owners and others is to gift long term capital gain assets to a **IRC Section 501(c)(3)** Charitable Organization that is Publicly Supported. A gift of a capital gain asset (one owned for 12 months or more) will qualify for a charitable donation deduction based on the full "fair market value" of the donated asset **without triggering any tax on the capital gain**!

This is an incredibly powerful income tax planning tool that works much better than the sale of the asset and donation of the cash sales proceeds. The difference in the two strategies is illustrated by the following example:

1. Comparison of Gift vs. Sale of Long-Term Capital Gain Real Estate. Facts. The business owner has taxable income of $200,000 in 2018, before

any sales of property or charitable contributions. The business owner has real estate that cost $10,000, but is currently worth $60,000. The business owner plans to make a gift of $60,000 to a 50% AGI limit charity. The source of the gift could be either the appreciated real estate or the proceeds of its sale.

2. **Comparison of Gift vs. Sale.** Assuming the business owner is not subject to the alternative minimum tax, the results of the two alternatives are as follows:

	Gift of Real Estate	Sale of Real Estate/ Gift of Proceeds
Taxable income prior to sale or donation	$200,000	$200,000
Contribution deduction		
(1). Gift of RE	(60,000)	
(2). Sale/Gift of proceeds		(60,000)
LTCG on sale	0	50,000
Taxable income	$140,000	$190,000
Income tax	$30,000	$40,000
Tax Savings by donating RE		$10,000

3. **Note.** The tax rates used for this example are illustrative only to show the effects of the donation of real estate as opposed to its sale and donation of the net proceeds. The assumed tax rate for income other than capital gains is 25% and the capital gains rate is 20% (Federal and NM taxes combined).

C. **Other Tax Rules to consider before making an Asset Donation.** There are significant advantages in certain situations to donors giving appreciated property to charity rather than selling the property and giving the proceeds to the charity. However, there are restrictions concerning the types of assets that qualify for

the full FMV deduction and limitations on the types of organizations that can receive that property, which will have an impact upon the donor's decision to donate an asset or to sell the asset and donate the proceeds.

1. **Property Other Than Long-Term Capital Gain Property.** Property which is limited in its deductibility to the donor's cost (i.e. non-LTCG property) will result in the same tax deduction for the donor whether the property itself is donated or the property is sold and the cash proceeds donated. However, this does not take into consideration any expense the donor would incur in selling the property.

2. **Business owners Subject to Alternative Minimum Tax.** A business owner who is subject to the alternative minimum tax ("AMT") on LTCG property will lose most of the benefits of the full FMV deduction for LTCG property donated to a charity. This is because the donor will have to pay the AMT on the difference between the fair market value and the cost of the asset. While the donor does not lose the full benefit of the FMV deduction the AMT can significantly reduce its benefits.

3. **Loss Assets.** An asset that has declined in value since its purchase by the donor should be sold rather than donated so that the business owner can deduct the loss. The net proceeds can then be donated to the charity in order to maximize the tax savings for the donor. Otherwise, the donation of the loss property to a charity will be limited to a charitable deduction of the FMV of the property, which results in the business owner losing a deduction for the loss.

4. **Gift of Tangible Personal Property.** The amount of a donor's deduction for gifts of tangible personal property ("TPP") (i.e. guns, art work, etc.) depends upon whether the item will be used by the charity in connection with its exempt purpose. Therefore, it is important to determine whether the donated TPP will be merely a gift "to" the charity, which will probably be sold or used in a non-tax exempt manner, or will it be a gift for the "use of" the charity in fulfilling its tax-exempt purpose?

5. **Attribution of Sale to the Donor.** Where a donated asset will be sold by the charity, it is extremely important for the donor to avoid participating in the negotiation of the sale with the intended buyer. The reason is that the IRS may be able to treat the sale as having been made by the donor, followed by a contribution of the sales proceeds, rather than a donation of the property itself. The donor is particularly vulnerable to this type of treatment by the IRS in cases where the sale was negotiated by the donor prior to the donation of the property to the charity.

6. **Disadvantages of Contributions of Real Estate.** A drawback to the donation of real estate, from the charity's point of view, is that unless it is income producing property, no immediate cash flow will be generated for the charity, and the charity will normally need to spend some of its own money in maintaining the property, especially if there is any debt associated with the property.

7. **Real Estate Subject to Debt.** From the donor's point of view, a potential drawback to the donation of real estate that is subject to debt (such as a

mortgage), is that the donation will result in a "deemed sale" of a portion of the property and a donation of the remainder of the property. When the charity either assumes the debt or takes the property subject to the debt, the donor is treated as receiving cash in the amount of the debt. This will generally result in the donor having to recognize a taxable gain on the portion of the property deemed to have been sold. Naturally, this will reduce the tax benefit of donating debt encumbered property when compared to a charitable contribution of unencumbered property.

VII. Conclusion. Attorneys who represent business owners have a great opportunity to assist their clients in recognizing the importance of establishing and maintaining an effective estate plan that minimizes taxes and Estate settlement expenses to the extent possible. Therefore, a basic understanding of Estate and Gift Tax laws and business related Income Tax issues by Attorneys representing business owners is essential for them to be able to encourage their clients to establish a well thought-out estate plan.

Estate Planning Strategies for Business Owners

Donald E. Swaim, Attorney/CPA

Property Ownership Controls

- How property is titled (owned) will control where it goes when you die.
- Automatic Transfers
  - Joint Tenancy with right of survivorship
  - Beneficiary Forms
  - "Pay on Death" and "Transfer on Death" transfers
- Probate Transfers
- Trust Transfers

JOINT TENANCY
(with right of survivorship)

- Assets held by two or more people as "**Joint Tenants**" **pass automatically** to the surviving Joint Tenants at Death.
- Assets held as "**Tenants in Common**" **do not** pass automatically to the surviving Joint Owners at Death.
- Assets held as "**Community Property**" **do not** automatically pass to the surviving spouse at Death.

JOINT TENANCY OWNERSHIP WITH A CHILD
(to plan for Incapacity and avoid Probate)

- Bill and Emily put Mary on their Bank Accounts and CDs as a **Joint Tenant**:
  - in case of Incapacity
  - to avoid Probate
- Bill and Emily put Mary on the Deed to their House as a **Joint Tenant**.
- Bill and Emily's Wills give equal shares of their assets to Mary, Tim and Paul.

What happens when Bill and Emily pass away?

1. Mary automatically inherits the Bank Accounts.
2. Mary automatically inherits the Certificates of Deposit.
3. Mary automatically inherits the House.

Other Automatic Transfers Can Cause Same Problems

- POD (Pay on Death) Accounts
- TOD (Transfer on Death) Accounts
- Life Insurance Beneficiary Forms
- IRA Beneficiary Forms
- Other Retirement Account Beneficiary Forms

THESE WILL OVERRIDE THE INSTRUCTIONS IN YOUR WILL!

WILLS

Wills Must Be Probated

- Wills do not work automatically. They must be "activated" by a Court to work.
- The Court process to activate a Will is call a "Probate".

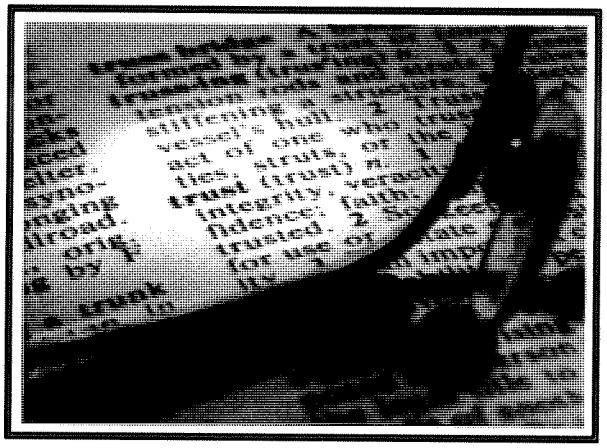
Wills Must be Probated
(continued)

- During the Probate of a Will, the Court:
  - Determines the validity of the Will
  - Appoints a Personal Representative for the Estate
  - Identifies the people who inherit assets under the terms of the Will
  - Determines who would inherit the Estate assets if the Will is not valid
  - Lists the assets and debts of the deceased person
  - Lists the income and expenses of the Estate
  - Identifies the assets distributed to the beneficiaries of the Will

Wills Must Be Probated
(continued)

- Probates are a matter of public record.
- Anyone who wants to can review all documents filed with the Court during a Probate.
- The legal fees charged for a simple, uncontested Probate (no fights, no complex assets) is $3,000 to $5,000.

TRUSTS



Types of Trusts used in Estate Planning

- Irrevocable Trusts – used for:
  - Providing protection for gifts and inheritances given to a beneficiary.
  - Gifting to minor, incapacitated or financially challenged beneficiaries.

- Revocable (Living) Trusts – used for:
  - Managing assets in the event the Grantor (Trust Owner) becomes incapacitated.
  - Avoiding Probate when the Grantor dies.

REVOCABLE TRUSTS

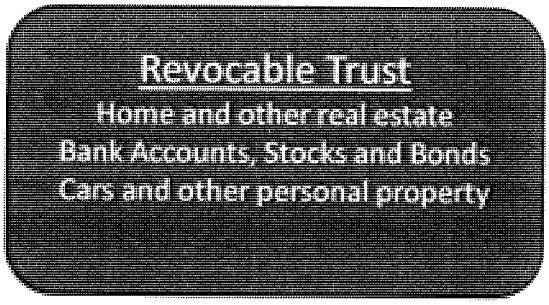
- Used in place of a Will to handle a person's estate plan.
- A Revocable Trust is nothing more than a "Fancy Will". It is fancy because:
  - Avoids Probate at death.
  - Avoids Court appointed Guardian and Conservator in case of incapacity.
  - Works better than a Will for estate tax planning.

REVOCABLE TRUSTS
(Continued)

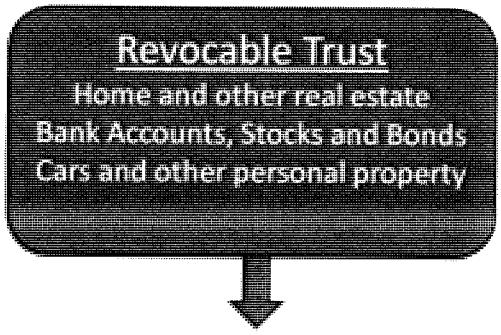
- A "Revocable Trust" and a "Living Trust" are the same thing.
- Using a Revocable Trust does not change your estate plan...it just carries it out more efficiently.
- Every Trust has a **Grantor** (person starting the Trust and making the rules), a **Trustee** (the Manager) and one or more **Beneficiaries** (the people entitled to get distributions from the Trust).

REVOCABLE TRUSTS
(Continued)

- A Trust is nothing more than a container to hold assets for someone.

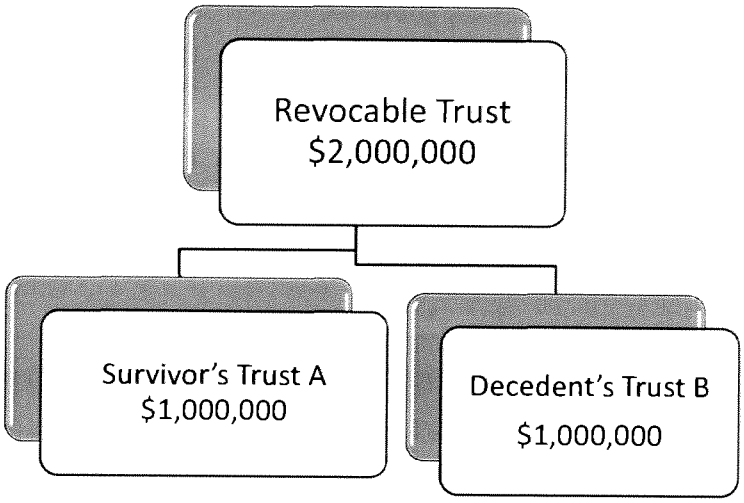


REVOCABLE TRUSTS
(Continued)



Trust assets distributed to the Trust Beneficiaries after the Grantor's death

REVOCABLE TRUSTS
(Continued)



REVOCABLE TRUSTS
(Continued)

- Estate Tax Savings - the A-B Trust can be designed to save estate taxes by assuring that both Grantors (spouses) get to use their estate tax exemption.

- Second Marriages - the A-B Trust can be designed to assure that the **deceased spouse** gets to control who receives Trust B's assets when the **surviving spouse** dies.

REVOCABLE TRUSTS
(Continued)

- The surviving Grantor can be the Trustee of Trust B.
- Distributions to the surviving Grantor from Trust B can be designed to fit your estate planning goals.
- Income and principal can be distributed for the survivor's "health, education, support and maintenance".
- Distribution standards can be restrictive or very liberal.

ESTATE AND GIFT TAX EXEMPTION FOR 2018

- Estate and Gift Tax Exemption = $11,180,000
- The Estate/Gift Tax Exemption is one combined exemption, not two separate exemptions.
- The exemption can be used to cover:
  - Taxable Gifts during lifetime
  - Assets remaining at death
- Married couples do not automatically get two exemptions.

NEW ESTATE AND GIFT TAX RATE FOR 2018

- 2018 Estate and Gift Tax Rate = 40%
- Estate/Gift Tax Rate under prior law = 41% to 55% (60% for some large Estates).
- Tax applies to amounts over the $11,180,000 exemption.

ESTATE TAX EXAMPLE:

Charlie Jones Estate Value at Death	$12,180,000
Less - 2018 Estate Tax Exemption	<11,180,000>
Taxable Estate	$ 1,000,000
Federal Tax Rate	x 40%
Federal Estate Tax Due	$ 400,000*

* Payment is due to the IRS 9 months after the date of death.

MARRIED COUPLE SIMPLE ESTATE PLAN

- Simple "I love you" Wills leave everything to Surviving Spouse.
- $13,180,00 in assets including personally owned life insurance.

Inheritance at 1st death	=	$ 6,590,000*
Survivor's Share of Assets	=	6,590,000
Total Asset Value		$13,180,000

* Unlimited Marital Deduction results in "no tax due" at first death.

MARRIED COUPLE SIMPLE ESTATE PLAN

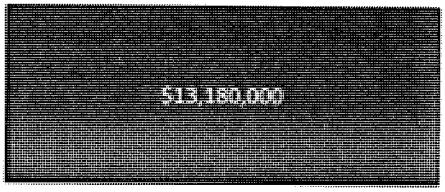
- What happens when the Surviving Spouse dies?

Surviving Spouse's Net Worth at death	$ 13,180,000*
Survivor's Estate Tax Exemption	<11,180,000>
Taxable Estate Value	$ 2,000,000
Federal Estate Tax Rate for 2013	x 40%
Estate Tax Due	$ 800,000

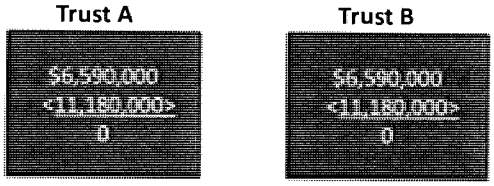
* Unlimited Marital Deduction is not an "Exemption". It only postpones ***when*** the first Spouse's assets are taxed!

A-B REVOCABLE TRUST

During Joint Lives



At First Death



Distribution at Second Death $13,180,000

A-B REVOCABLE TRUST (continued)

- Saves Estate Tax by using both Spouses Exemptions.
- Trust B is protected from Surviving Spouse Creditors and Law Suits.
- Trust B protects Deceased Spouse's Estate Plan.
- Great for Second Marriages
  - Provide for Surviving Spouse without disinheriting the Kids from prior marriage.

THE "PORTABILITY EXEMPTION"

- The 2013 Estate Tax Law made the **Portability Exemption** permanent.
- The **Portability Exemption** is the Government's version of an A-B Trust for couples who did not effectively plan for Estate Taxes.
- The **Portability Exemption** allows the Surviving Spouse to capture the Deceased Spouse's unused Estate Tax Exemption.
- The Surviving Spouse can use the Deceased Spouse's **Portability Exemption** for lifetime gifts or at death.

THE PORTABILITY EXEMPTION (continued)

- A Federal Estate Tax Return (Form 706) must be filed with the IRS to claim to Portability Exemption:
  - Formal Appraisal of Assets required.
  - Must be filed within 9 months of death (but can be 15 months with valid extension of time to file).
  - Requires the help of a CPA or Tax Lawyer (or both) to complete.
  - IRS says Form 706 must be complete in all respects for Portability Exemption to be available to the Surviving Spouse.
  - Costs can be $7,500 to $15,000 or more to complete Form 706.

TRUST B
ONCE EXEMPT..... ALWAYS EXEMPT

Trust B - Value at First Spouse's Death

Trust B
Asset Value
$ 5,430,000

TRUST B
ONCE EXEMPT..... ALWAYS EXEMPT

Trust B - After 5 Years

Trust B
Asset Value
$ 7,430,000

TRUST B

ONCE EXEMPT..... ALWAYS EXEMPT

Trust B - After 10 Years

Trust B
Asset Value
$ 9,180,000

PORTABILITY EXEMPTION

ONCE SET.....FROZEN FOREVER

Portability Exemption - Value at First Spouse's Death

Portability Exemption
Asset Value
$ 5,430,000

PORTABILITY EXEMPTION
ONCE SET.....FROZEN FOREVER

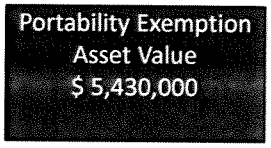
Asset Value after 5 Yrs. = $7,430,000

$ 2,000,000 x 40% = $800,000 Estate Tax

Value "Outside the Box" is Not Covered by the Portability Exemption !

PORTABILITY EXEMPTION
ONCE SET.....FROZEN FOREVER

Asset Value after 10 Yrs. = $9,180,000



$ 3,750,000 x 40% = $1,500,000 Estate Tax

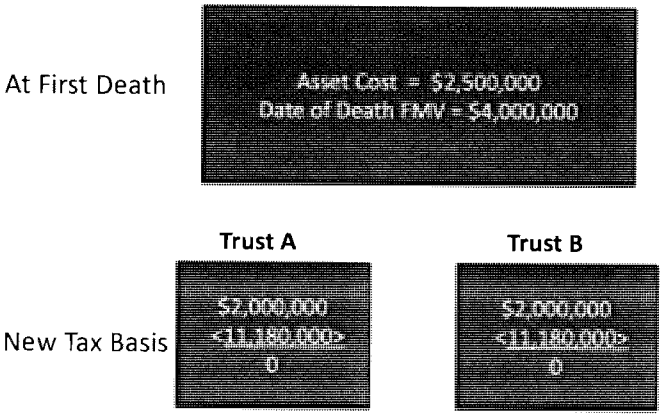
Value "Outside the Box" is Not Covered by the Portability Exemption !

COMPARISON of the **PORTABILITY EXEMPTION** and an **A-B TRUST**

- "A-B Trust" provides Surviving Spouse with protection from:
  - Future Spouses and Divorce
  - Law Suits
  - Estate Tax
  - Increase in value of Deceased Spouse's Assets in Trust B

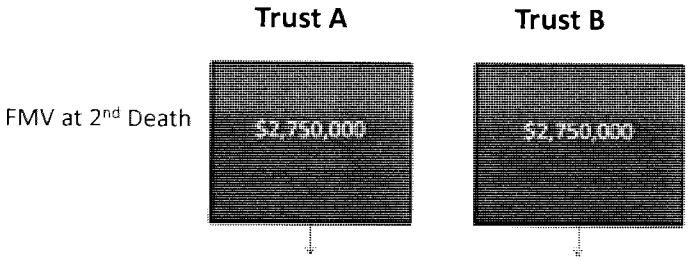
- "Portability Exemption" provides Surviving Spouse with protection from:
  - Estate Tax on initial amount of Portability Exemption.
  - But does not protect the **increase in value** of Deceased Spouse's Assets in Trust B (Portability Exemption does not grow as assets grow).

A-B REVOCABLE TRUST – Step-up in Tax Basis



IRC Section 1014(b)(1) and (6) = Step-up in Basis of Community Property on both halves, not just the Decedent's half!

A-B REVOCABLE TRUST – Step-up in Tax Basis



	Trust A	Trust B
Sale Price	$2,750,000	$2,750,000
Tax Basis	-2,750,000	-2,000,000
Taxable Gain	0	$ 750,000

ESTATE PLANNING STRATEGIES FOR 2018

- Simple Revocable Trust = Assets $2,500,000 to $3,000,000
- Traditional A-B Trust = Assets $3,000,000 +
- A-B (Qtip) Trust = Assets $3,000,000 +

Note - Portability Exemption Election can be used with be used with any of these strategies!

Option 1
SIMPLE REVOCABLE TRUST

Revocable Trust
Similar to "I love you Will".
Everything left to Survivor.
Survivor can Amend or Revoke the Trust.

Trust assets distributed to the Trust Beneficiaries after the Grantor's death

Option 2
A-B REVOCABLE TRUST

During Joint Lives

$5,000,000

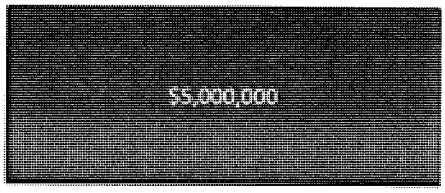
At First Death

Trust A	Trust B
$2,500,000	$2,500,000
<11,180,000>	<11,180,000>
0	0

Distribution at Second Death gets a Step-Up in Income Tax Basis for Trust A assets, but not for Trust B assets.

Option 3
A-B (Qtip) REVOCABLE TRUST

During Joint Lives



At First Death

Trust A	Trust B (Qtip)
$2,500,000	$2,500,000
<1,180,000>	<1,180,000>
0	0

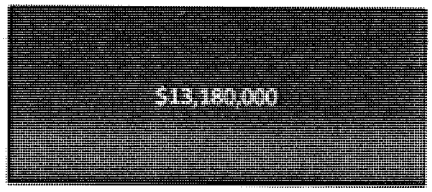
Distribution at Second Death gets a Step-Up in Income Tax Basis for Trust A assets and Trust B assets.

A-B (Qtip) REVOCABLE TRUST – Step-up in Tax Basis

	Trust A	Trust B (Qtip)
FMV at 2nd Death	$2,750,000	$2,750,000
Sale Price	$2,750,000	$2,750,000
Tax Basis	-2,750,000	-2,750,000
Taxable Gain	$ 0	$ 0

Option 4
The Ultimate Estate Plan for 2018

During Joint Lives



	Trust A	Trust B (Qtip)	Portability Exemption
At 1st Death	$6,590,000 <11,180,000> 0	$6,590,000 <0> $6,590,000	$11,180,000

* Deceased Spouse's ET Exemption not used, so full Portability Exemption is available for the Surviving Spouse to Claim.

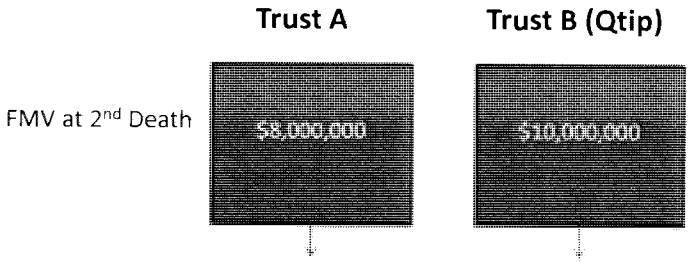
Option 4
The Ultimate Estate Plan for 2018

	Trust A	Trust B (Qtip)	Portability Exemption
At 2nd Death	$8,000,000	$10,000,000	$11,180,000

Survivor's Estate

Trust A	$ 8,000,000
Trust B (Qtip)	10,000,000
Total Estate	$18,000,000
Survivor's Exemption	(11,180,000)
Portability Exemption	(11,180,000)
Taxable Estate	$ 0

A-B (Qtip) REVOCABLE TRUST – Step-up in Tax Basis



	Trust A	Trust B (Qtip)
Sale Price	$8,000,000	$10,000,000
Tax Basis	-8,000,000	-10,000,000
Taxable Gain	$ 0	$ 0

Generation Skipping Tax Exemption for 2013

- GST Exemption for 2013 = $5,340,000
- The GST Exemption is a totally separate exemption from the Estate and Gift tax exemption.
- Applies to gifts and inheritances transferred to children or grandchildren that will not be taxable when the children die.
- Example - Lifetime Trust for Child that passes to Grandchild at the Child's death.

Generation Skipping Tax Exemption for 2013 (continued)

- GST Tax Rate for 2013 = 40%
- GST Tax is paid **in addition to** any Estate Tax or Gift Tax due.
- Example - Dad skips Daughter and leaves Estate to Grandson:

Estate Value	$8,000,000
Less – Estate Tax Exemption	<5,340,000>
Taxable Estate	$2,660,000
Estate Tax Rate	x 40%
Estate Tax Due	$1,064,000

Generation Skipping Tax Exemption Example:

Estate Value	$8,000,000
Less – Estate Tax Paid	<1,064,000>
Net Estate GC Received	$6,936,000
GST Tax Exemption	<5,340,000>
GST Taxable Inheritance	$1,596,000
GST Tax Rate	x 40%
GST Tax Due	$ 638,400
Plus Estate Tax Paid	1,100,000
Combined Estate & GST Tax	$ 1,738,400 *

* **(results in a 64% effective tax rate on taxable part of GST transfers)**

PLANNING FOR CHILDREN'S INHERITANCE

- Distributions to Children can be Structured to fit their needs:

1. Outright distributions to responsible adult children.
2. Distributions over time to adult children who need to learn money management skills.
3. Lifetime Trusts for adult children who cannot manage money themselves.

PLANNING FOR CHILDREN'S INHERITANCE

- Structuring Distributions for **Minor/Younger Children** until they grow up:

1. Assets held in a Trust and managed by a Trustee.
2. Trust can be designed to distribute money to the Child's Guardian for the Child's health, education, support and maintenance needs.
3. Distributions can be made at certain Ages ($1/4^{th}$ at 25; $1/4^{th}$ at 30; $1/4^{th}$ at 35; $1/4^{th}$ at 40).
4. Distributions can be made on occurrence of an Event (Graduation from College, Marriage, Birth of a Child).

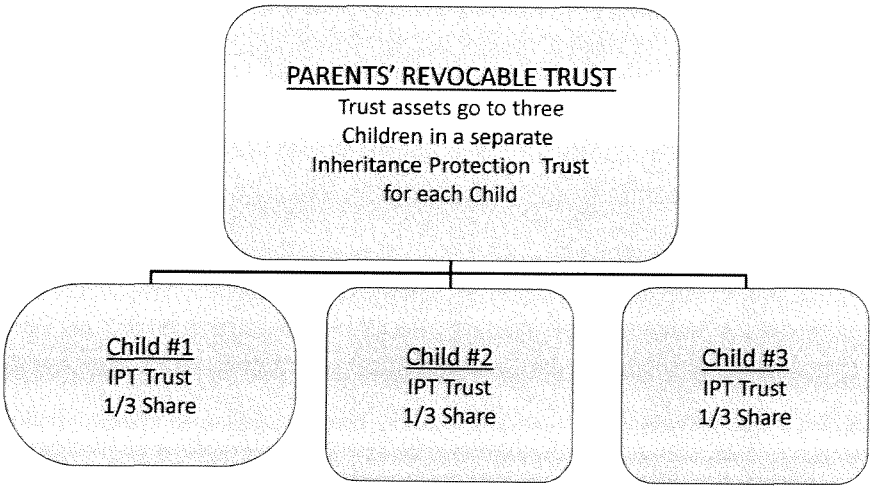
PLANNING FOR CHILDREN'S INHERITANCE

- Is my Child's Inheritance Protected from:
  - **Divorce**?
  - **Creditors**?
  - **Future Estate Taxes**?
  - **Inlaws and Outlaws**?
- **"No!"** Not after the Inheritance has been distributed to your Child.
- But... You can provide protection for your Child by distributing the Child's Inheritance to an **"Inheritance Protection Trust"**.

INHERITANCE PROTECTION TRUST (continued)

- The Concept - To create a separate **Inheritance Protection Trust** ("**IPT Trust**") for each child.
- Each Child's **IPT Trust** provides protection from:
  - Divorce
  - Law Suits
  - Estate Tax
  - In Laws (and Outlaws!)

INHERITANCE PROTECTION TRUST
(the Gift that keeps on Giving)



INHERITANCE PROTECTION TRUST
(continued)

- NM law allows Child to be the Trustee of **IPT Trust** without losing Creditor protection.
- Distributions to the Child from an **IPT Trust** can be designed to fit your estate planning goals:
  - Income and principal can be distributed for the Child's "health, education, support and maintenance".
  - Distribution standards can be restrictive or very liberal.
  - Can use an Independent Trustee if Child needs help managing financial assets.

LIFE INSURANCE
(The Ultimate Problem Solver)

- Top Ten Uses of Life Insurance in Estate Planning :
  1. Second Marriages
  2. Payment of Estate Taxes
  3. Payment of Income Taxes on IRA and 401(k) Distributions
  4. Young Families
  5. Large Debts
  6. Business Buyouts
  7. Key Man Insurance
  8. Private Retirement Plan
  9. Inheritance Equalization or Creation
  10. Charitable Gifts

TAXATION OF LIFE INSURANCE

- Beneficiaries do not pay income tax on Life Insurance Proceeds.
- ***However***... Life Insurance Proceeds **are taxable** as part of the Decedent's Estate if Decedent or Spouse owns the Policy, can borrow from it or can name beneficiaries.
- Proceeds from Life Insurance owned by another person or a **Life Insurance Trust are not taxable.**

TAXATION OF LIFE INSURANCE

Personally Owned Insurance	Trust Owned Insurance
	
Bob owns a $2,000,000 Insurance Policy payable to his three kids.	Kids are beneficiaries.
Estate Tax at Death = $800,000	Estate Tax at Death = $ 0

GIFT TAX PLANNING FOR 2018

- Annual Nontaxable Gift Limit = **$15,000** per person, per year.
- Taxable Gifts = anything over **$15,000** to one person in one year. Also, gifts the beneficiary cannot use currently.
- Gifts to Irrevocable Trusts – Don't qualify for **$15,000** NT gift limit, unless beneficiary has right to receive the gift currently. [The "Crummy Trust"].
- Crummey W/D Right - Giving beneficiary the right to withdraw the gift = NT current gift up to the **$15,000** limit.

GIFT vs. **INHERITANCE**
(Income Tax Basis Comparison)

Basis of Gifted Assets	**Basis of Inherited Assets**
• Donor's Cost Basis	• Date of Death Value Basis
• Sale of gifted asset for more than Donor's Cost = taxable capital gain.	• Sale of asset for Date of Death Value = no taxable capital gain.
• Charitable donation of same asset = full "fair market value" tax deduction.	• **Punch-line** - It is better to inherit assets that have increased in value.

GIFT vs. **INHERITANCE**
(Income Tax Basis Example)

- Bob paid $20,000 for Land now worth $100,000.
- Gift to Son who then sells the Land:
  - Sales Price $100,000
  - Tax Basis (Dad's cost) <20,000>
  - Taxable Capital Gain $ 80,000
- Son Inherits and then sells the Land:
  - Sales Price $100,000
  - Tax Basis (Date of Death) <100,000>
  - Taxable Capital Gain $ 0

GIFT vs. INHERITANCE

- Example - Mom wants to gift stock to Daughter worth $250,000 she paid $50,000 for in 2001.

	Sale	Gift	Inheritance
Stock	Mom	Daughter	Daughter
FMV	$250,000	$250,000	$250,000
Basis	<50,000>	<50,000>	<250,000>
Gain	$200,000	$200,000	$ 0

Note - **No tax due on sale of inherited Stock!**

GIFT vs. INHERITANCE

- Example - Mom wants to gift her home to Daughter worth $300,000 she paid $75,000 for in 1984.

	Sale	Gift	Inheritance
Home	Mom	Daughter	Daughter
FMV	$300,000	$300,000	$300,000
Basis	<75,000>	<75,000>	<300,000>
Gain	$225,000	$225,000	$ 0
Exclusion	<250,000>	0	<250,000>
Taxable	$ 0	$225,000	$ 0

GIFT vs. INHERITANCE

- Example - Mom wants to gift IRA to Son worth $150,000.

	Distribution	Gift	Inheritance
IRA	Mom	Son	Son
FMV	$150,000	$150,000	$150,000
Basis	<0>	<0>	<0>
Gain	$150,000	$150,000	$150,000

Note - **Someone always has to pay tax on an IRA! [or do they?]**

IRA INHERITANCE BY CHILD vs. CHARITY

- Example - Mom wants to leave $150,000 each to **UNM** and her Son. She has an IRA worth $150,000 and a CD worth $150,000. Which should she gift to her Son?

	Inheritance to Son	Inheritance to **UNM**
IRA	**Taxable**	**Nontaxable**
Tax Due	$60,000	$ 0
CD	**Nontaxable**	**Nontaxable**
Tax Due	$ 0	$ 0

- Note – **Knowing what to give to who really pays off!**

Gift of Appreciated Stock to Charity

- Gift of appreciated stock to a 501(c)(3) publicly supported charity =
  - + Full "fair market value" charitable deduction.
  - + No income tax due on built-in capital gain.

Example - Cathy has stock worth $100,000 she bought for $20,000. Cathy gets a charitable donation deduction of $100,000 and **does not** have to pay tax on the $80,000 built-in capital gain.

Sale of Appreciated Stock and Donation of Net Proceeds to Charity

- Sale of appreciated stock and donation of net proceeds to a 501(c)(3) publicly supported charity =
  - + Full charitable deduction for amount of proceeds gifted.
  - + Income tax is due on built-in capital gain.

Example - Cathy sells stock for $100,000 she bought for $20,000. Cathy has to pay **$20,000 capital gains tax** on the $80,000 built-in capital gain.

Sale vs. Donation of Appreciated Stock to Charity

	Sell and Donate Proceeds	Donate Stock
Stock FMV	$100,000	$100,000
Basis	<20,000>	<20,000>
Long-term CG	$ 80,000	$ 80,000
CG Tax Due	**$ 20,000**	$ 0
Tax Deduction	$ 80,000	$100,000
Tax Savings (30%)	**$ 24,000**	**$ 30,000**
Net Tax Savings	**$ 4,000**	**$ 30,000**

GIFT vs. **INHERITANCE**

- Gifts only make sense when the Estate **exceeds** the $11,180,000 Exemption.
- Gift **high basis assets** first whenever possible.
- Inheritance is best if no Estate Tax will be due.

TRUST OWNERSHIP OF S CORPORATION STOCK

- Three types of Trust can own S Corporation Shares:
  1. A Grantor Trust
  2. A QSST Trust
  3. An ESBT Trust
- Other Trusts - Ownership of S Corp. Stock by any other Trust will **terminate the S Election**.
- Result of Terminating an S Election – The Corporation becomes a C Corporation. C Corporation profits are subject to **double taxation**.

GRANTOR TRUSTS

- Grantor Trusts are Ignored for Income Tax Purposes
- IRC Sections 671 – 678 contain the Grantor Trust Rules
- The Grantor is treated as being the owner of the Trust's assets
- Most Common Types of Grantor Trusts:
  1. Revocable Trusts
  2. Living Trusts
  3. Grantor Retained Interest or Powers Trusts

QSST TRUSTS
(Qualified Subchapter S Trusts)

- Beneficiary treated as S Stock Owner
- IRC Section 1361 contains the QSST Rules
- QSST Requirements:
    1. Trust can only have 1 Beneficiary.
    2. All S Corp. "Trust Income" distributed annually.
    3. No principal distributions to anyone but the Beneficiary.
    4. Assets distributed to the Beneficiary if Trust terminates.
    5. Beneficiary must file an Election with the IRS.

ESBT TRUSTS
(Electing Small Business Trusts)

- Trust treated as S Stock Owner – Pays tax on S Corp. Income at highest Individual Federal Tax Rate (a flat tax rate).
- IRC Section 1361 contains the ESBT Rules.
- ESBT Requirements:
    1. Trust can have multiple Beneficiaries.
    2. Beneficiaries must be people and/or Charities.
    3. No Charitable Remainder Trusts allowed.
    4. All S Corp. Income taxed to the Trust even if distributed.
    5. Trust can't buy S Corp. Shares.
    6. Trustee must file an Election with the IRS.

TRUSTEED BUY-SELL AGREEMENTS

- Used to avoid problems encountered with Shareholders and Family when a Cross-Purchase Agreement is used.

- Two types of Trusts used for Cross-Purchase Agreements:
  1. Joint Irrevocable Life Insurance Trust ("ILIT")
  2. Individual ILITs for each Shareholder.
- Avoids Problems with:
  - Refusal to sell Shares at set price
  - Refusal to use life insurance proceeds to buy Shares.
  - Incapacitated or Incompetent survivors.

TRUSTEED BUY-SELL AGREEMENTS - Continued -

- Joint Irrevocable Life Insurance Trust ("ILIT")
  1. A single Irrevocable Trust used.
  2. Operates like an Escrow Company.
  3. Trust owns the Life Insurance Policies.
  4. Trust holds all S/Hs' Shares in Escrow.
  5. Trustee collects Life Ins. proceeds and buys shares.
  6. Shares distributed to deceased S/H's Heirs.
- Specialized Drafting required to avoid:
  - Estate tax inclusion
  - IRC Section 101 – "Transfer for Value" Rules

TRUSTEED BUY-SELL AGREEMENTS
- Continued -

- Individual Irrevocable Life Insurance Trusts:
  1. Each S/H sets up an ILIT.
  2. ILIT will own Life Insurance Policies on other S/Hs.
  3. ILIT can be used for the S/H's Estate Planning.
  4. Trust does not hold S/H's or other S/Hs' shares.
  5. Trustee collects Life Ins. proceeds and buys shares.
  6. Shares held by Trust for benefit of S/H's Heirs.
- Specialized Drafting required to avoid:
  - Estate tax inclusion
  - IRC Section 101 – "Transfer for Value" Rules

TRUSTEED BUY-SELL AGREEMENTS
- Continued -

- Avoiding Estate Tax Inclusion of Life Insurance Proceeds:

  1. Problem is greater with the Joint ILIT, but can be a problem for both types.

  2. Joint ILIT must keep a S/H from having "incidents of ownership" in the S/H's own life insurance policy.

  3. Use an Independent Trustee, not a S/H or Employee.

TRUSTEED BUY-SELL AGREEMENTS
- Continued -

- IRC Section 101 Transfer for Value Problem:
  1. Section 101 makes Life Insurance proceeds taxable if the policy is transferred from original owner to another person for money or other consideration.
  2. IRS treats increase in ownership percentage of Surviving S/Hs in Joint ILIT as a "transfer for value".
  3. IRS treats right to acquire Surviving S/H's policy as a "transfer for value" for both types of Trust.

TRUSTEED BUY-SELL AGREEMENTS
- Continued -

- Avoiding the IRC Section 101 Transfer for Value Problem:
  1. Section 101 provides an exception a policy transferred to a Partner of the Insured Person.
  2. Partnership does not have to be related to the business covered by the Buy-Sell Agreement.
  3. Partnership can be of small value and can own an investment account or Certificate of Deposit.

TRUSTEED BUY-SELL AGREEMENTS
- Continued -

- Avoiding the IRC Section 101 Transfer for Value Problem:

    4. All S/Hs and all ILITs should be Partners.

    5. Partnership must be valid under State law.

    6. Partnership interests of deceased Partners should be purchased under terms of the Buy-Sell Agreement.

Key Points Points to Remember

1. Asset ownership must be coordinated with your Client's estate planning documents (Will or Trust) to work effectively.

2. Estate and Gift Tax Exemptions are never permanent.

3. Use of an A-B (Qtip) Trust plus Portability Exemption should be used for best results and flexibility.

4. Client's traditional A-B Trust EP can be dangerous to your Client's wealth!

Thank You

NOTES

Insurance Coverage Issues for Business Owners

NOTES

There's No Business like Grow Business/Medical Marijuana and Other Smoking-Hot Ethics Topics for Business Lawyers

THERE'S NO BUSINESS LIKE GROW BUSINESS: MEDICAL MARIJUANA AND OTHER SMOKING-HOT ETHICS TOPICS FOR BUSINESS LAWYERS

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The past twelve months have seen several notable developments in legal ethics locally and on a national level, some of which may be of particular interest to business lawyers.

I. Representing Medical Marijuana Businesses

Medical marijuana is big business. At last count, thirty-one states and the District of Columbia had legalized it, and the legal-cannabis industry as a whole – including businesses in nine jurisdictions whose legislators have approved recreational use – is on track to generate $11 billion in sales this year, by some estimates. Among the states on the medical-marijuana bandwagon is New Mexico, where the Lynn and Erin Compassionate Use Act ("Compassionate Use Act"), NMSA 1978, §§ 26-2B-1 to -7 (2007), has been on the books for the past eleven years. The New Mexico Department of Health has promulgated dozens of detailed regulations under the statute, and the "non-profit" entities contemplated by the regulations – as well as the for-profit entities lurking in the background – will need legal advice and representation on a regular basis. What's not for a business lawyer to love about this burgeoning market?

There's just one little problem: marijuana remains a flower non grata under federal law. The Controlled Substances Act of 1970 classified marijuana as a Schedule I controlled substance, thereby documenting Congress's determination that marijuana – like heroin, LSD, and ecstasy – had "a high potential for abuse," "no currently accepted medical use in treatment in the United States," and "a lack of accepted safety for use ... under medical supervision." 21 U.S.C. § 812(b)(1). Thanks to this classification, it's a federal crime to possess, distribute, or dispense marijuana, and prescribing marijuana as a medication is no less unlawful. Efforts to remove marijuana from Schedule I, such as the Marijuana Justice Act of 2017 – or to exempt medical marijuana from federal law when it is produced, possessed, recommended, distributed, dispensed, or delivered in accordance with state law, such as the Compassionate Access, Research, Expansion, and Respect States ("CARERS") Act of 2017 – have gone nowhere to date, even though 64% of Americans favor legalization, according to the latest Gallup poll.

In New Mexico and elsewhere, marijuana's persistent illegality under federal law has posed an ethical dilemma for lawyers seeking to serve medical marijuana businesses that are welcomed by state law. Rule 16-102 of the New Mexico Rules of Professional Conduct, similarly to the American Bar Association's Model Rule 1.2, provides that

> [a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal .... A lawyer may, however, discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a

> good faith effort to determine the validity, scope, meaning or application of the law.

Rule 16-102(D) NMRA (attached as Exhibit A hereto). This language has spawned a variety of answers across the country to the question whether lawyers can ethically represent medical marijuana entrepreneurs in states whose laws are otherwise hospitable to the industry.

In New Mexico, the State Bar's Ethics Advisory Committee ("Committee") took its first crack at the question two years ago. It did so in the wake of the supreme court's rejection of a 2015 proposal, see 54 N.M. Bar Bull. No. 11, at 17 (Mar. 18, 2015), that would have added to Rule 16-102 a subsection (E) authorizing attorneys to "counsel or assist a client regarding conduct expressly permitted by the Lynn and Erin Compassionate Use Act." N.M. State Bar Ethics Advisory Comm., Formal Op. 2016-01 (withdrawn), reprinted in 55 N.M. Bar Bull. No. 32, at 17, 19 n.1 (Aug. 10, 2016) (attached hereto as Exhibit B). Although the Committee had no trouble declaring that a lawyer "may 'represent' a medical cannabis business in so far as to advise it on the legality of its proposed activities," the Committee found it "much less clear ... [that] a lawyer can actually 'represent' such a business for substantive business-related purposes, such as creating an LLC, negotiating contracts, or other possible tax and business representation." Id. at 17. Because Rule 16-102(D) prohibits a lawyer from "counsel[ing] a client to engage, or assist[ing] a client, in conduct that the lawyer knows is criminal" – and because "producing and distributing any type of cannabis, including medical cannabis permitted under state laws, is illegal under federal law" – the Committee concluded that "a lawyer may not provide prohibited counseling or assistance." Id.

At the same time, the Committee was "unable to agree as to the exact parameters of 'assistance.'" Exhibit B, at 18. The Committee generally agreed that "negotiating contracts for the purchase of cannabis would be directly assisting the client to engage in criminal activity." Id. But at least some Committee members believed that, "[a]t the other end of the spectrum, ... forming a general alternative medical business, which could possibly include the prescription and distribution of medical cannabis would not be such assistance." Id. Ultimately, the Committee left it to individual attorneys to "draw the line of 'assistance' for themselves, bearing in mind that that line may be tested through a disciplinary complaint." Id.

The suggestion that New Mexico attorneys should subject themselves to Disciplinary Board proceedings to flesh out the meaning of Rule 16-102(D) had a predictably inhibiting impact on a traditionally risk-averse profession. See, e.g., Brian Melley, Lawyers walk fine line to navigate state, federal pot laws, Albuquerque J. (Dec. 3, 2017) ("Attorney Larry Donahue had several medical marijuana clients at his firm in Albuquerque ... until the [Committee] issued [its] ... opinion .... Donahue had to terminate four or five clients. 'It was a very chilling opinion,' he said. 'It basically scared the hell out of us.'"). Even more unsettling was the Committee's admonition that "attorneys with multiple licenses or on inactive status in New Mexico are equally subject to our Rules of Professional Conduct for activities conducted in other jurisdictions." Exhibit B, at 18. Thus, the pall cast by the Committee's opinion extended to "New Mexico attorneys representing medical cannabis businesses in states that ... specifically permit such representation under their rules." Id.

In apparent response to the Committee's opinion, the supreme court approved insertion of the following passage in the commentary to Rule 16-102(D), effective on August 1, 2017:

> As an illustration, a lawyer may counsel or assist a client regarding conduct expressly permitted by the Lynn and Erin Compassionate Use Act, NMSA 1978, §§ 26-2B-1 to -7, and may assist a client in conduct that the lawyer reasonably believes is permitted by the Act. When that advice or assistance is given, the lawyer shall counsel the client about the potential legal consequences, under federal and other applicable law, of the client's proposed course of conduct.

Rule 16-102(D) cmt. 11. The first sentence of this passage is essentially the language that the supreme court previously declined to add to the text of Rule 16-102 as a new subsection (E). The second sentence adopts the substance of a directive that the Colorado Supreme Court incorporated into the commentary to Colorado's version of the rule. See Exhibit B, at 18.

After reviewing the beefed-up comment 11 to Rule 16-102(D), the Committee withdrew Formal Opinion 2016-01 and issued a new opinion "interpret[ing] the commentary to mean [that] attorneys may assist medical cannabis entities with ordinary legal services that law firms typically provide to businesses and non-profit corporations, such as assistance with business formation and the drafting of contracts[,] without facing disciplinary action." N.M. State Bar Ethics Advisory Comm., Informal Op. 2017-013, at 4 (Apr. 17, 2018) (attached hereto as Exhibit C). But the Committee added:

> [B]ecause the language of the Rule [itself] is unchanged, and the commentary has not specifically provided additional guidance as to the meaning of "assist" or "criminal," ... attorneys [should] not ... take the amended commentary as a broad license to assist clients in other conduct that may be illegal under state or federal law that is not expressly covered by the Compassionate Use Act. For similar reasons, attorneys should be cautious about providing assistance that goes beyond the ordinary services that law firms typically provide[] to businesses and non-profit corporations. Attorneys should also consider whether their assistance may itself be criminal under federal law, in light of Rule 16-804(B) & (D) NMRA's prohibition of unlawful conduct that reflects adversely on the lawyer's fitness or that is prejudicial to the administration of justice.

Id.

The Committee has not yet acted on a request that it issue this opinion formally to the entire bar. Presumably, however, the opinion reflects the Committee's considered judgment; and for New Mexico attorneys seeking to represent medical marijuana businesses, it ought to provide considerably more comfort than the withdrawn Formal Opinion 2016-01. Even so, the

Committee's opinion and the rule's new commentary contain caveats that demand careful consideration by any business lawyer aiming to break into this practice area.

A. "[T]he lawyer shall counsel the client about the potential legal consequences, under federal and other applicable law, of the client's proposed course of conduct." – As noted above, medical marijuana remains illegal under federal law, irrespective of its status under the Compassionate Use Act. But "[f]ederal laws and policies are broad, detailed, and complex.... Lawyers therefore should not be comfortable that they are fully complying with their ethical obligations by summarily telling the client that the conduct is prohibited by federal law." Bruce E. Reinhart, Dazed & Confused: Legal and Ethical Pitfalls in Marijuana Law, Crim. Just., Winter 2017, at 4, 5, available at https://americanbar.org/content/.../CJ_v031n04_Reinhart.authcheckdam.pdf.

Consider, for starters, federal criminal law – a body of law about which business lawyers tend not to be experts. Cf. Rule 16-101 NMRA ("A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation."). Knowingly or intentionally manufacturing, distributing, or dispensing a Schedule I controlled substance – or possessing it with intent to manufacture, distribute, or dispense it – can lead to a life sentence. See 21 U.S.C. § 841(a). And no doctor can lawfully prescribe such a substance. That the Compassionate Use Act authorizes a doctor to "certif[y]" patients for medical marijuana, § 26-2B-4(E), does not immunize the doctor from federal prosecution for an activity tantamount to prescribing. See Bruce E. Reinhart, supra, at 6.

Medical marijuana proponents began breathing more easily in August 2013, when Deputy Attorney General James M. Cole issued what has come to be known as the "Cole Memorandum." Generally speaking, the Cole Memorandum instructed federal prosecutors to avoid bringing criminal charges against marijuana businesses that were complying with state law, at least in any state having "a strong and effective ... regulatory system." See James M. Cole, Deputy Att'y Gen., Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement (Aug. 29, 2013). But earlier this year, Attorney General Jeff Sessions rescinded the Cole Memorandum and related communiques, "effective immediately." Jefferson B. Sessions, III, Att'y Gen., Memorandum for All United States Attorneys: Marijuana Enforcement (Jan. 4, 2018) (attached hereto as Exhibit D). In doing so, he reminded federal prosecutors that the Controlled Substances Act establishes "significant penalties" for the cultivation and distribution of marijuana, and he emphasized what he described as "Congress's determination that marijuana is a dangerous drug and that marijuana activity is a serious crime." Id.

Currently, the only thing standing between medical marijuana businesses and prosecution under the Controlled Substances Act – aside from public opinion and common sense – is Congress's appropriations power. Since 2015, a recurring rider now known as the Rohrabacher-Blumenauer Amendment has prohibited the Department of Justice from using appropriated funds to prevent states from "implementing their own laws that authorize the use, distribution, possession, or cultivation of medical marijuana." But the latest renewal of that rider will expire in December unless Congress and the President take action to extend it.

In any event, criminal prosecution is not the only risk that federal law creates for medical marijuana businesses. Civil fines and forfeitures are additional weapons in federal law enforcers' arsenal, see, e.g., 18 U.S.C. §§ 981, 983; 21 U.S.C. § 856(d); Bruce E. Reinhart, supra p. 4, at 7-8, though the Rohrabacher-Blumenauer Amendment may prohibit the Justice Department from deploying them for the time being. The Bankruptcy Appellate Panel of the Tenth Circuit has held that marijuana businesses can't avail themselves of federal bankruptcy law. See In re Arenas, 535 B.R. 845 (B.A.P. 10th Cir. 2015). "[T]he IRS consistently denies business deductions to state-sanctioned marijuana dispensaries under 26 U.S.C. § 280E, which prohibits 'any deduction or credit' for any business that 'consists of trafficking in controlled substances [within the meaning of the Controlled Substances Act].'" Alpenglow Botanicals, LLC v. United States, 894 F.3d 1187, 1193 (10th Cir. 2018). And the crime-fraud exception to the attorney-client privilege may render the client's communications with the attorney, and the attorney's advice to the client, discoverable. See, e.g., Rule 11-503(D)(1) NMRA.

B. "[A]ttorneys [should] not ... take the amended commentary as a broad license to assist clients in other conduct that may be illegal under state or federal law that is not expressly covered by the Compassionate Use Act." – The Compassionate Use Act concerns the conduct of "qualified patient[s]," "licensed producer[s]," and "certif[ying]" doctors, see § 26-2B-3(D), (G), (H); § 26-2B-4; and the Department of Health has undertaken to regulate the activities of "testing laboratories" and "couriers" as well, see 7.34.4.15 through 7.34.4.17 NMAC. But medical marijuana businesses necessarily depend on many other economic actors, including landlords, lenders, investors, vendors, and other "ancillary service providers." Federal criminal statutes are broad enough to permit the prosecution of these individuals and entities as co-conspirators or aiders and abettors. See Bruce E. Reinhart, supra p. 4, at 5, 7. May a lawyer ethically represent such persons and companies in their dealings with medical marijuana businesses, even though their activities "may be illegal under ... federal law [and are] not expressly covered by the Compassionate Use Act"? One assumes so, since the industry could not exist without them. But neither the supreme court commentary nor the Committee opinion is clear on the point.

C. "[A]ttorneys should be cautious about providing assistance that goes beyond the ordinary services that law firms typically provide[] to businesses and non-profit corporations." – This advice is sound in any context, but it takes on special significance for lawyers representing medical marijuana businesses. Because banks have been notoriously skittish about accepting deposits from medical marijuana businesses, most such businesses operate largely or even exclusively in cash. More than most clients, then, medical marijuana businesses may wish to have their lawyers perform bank-like functions or to act as their escrow agents. Their lawyers should resist the temptation, no matter how sympathetic the clients' unbanked plight may be.

D. "Attorneys should also consider whether their assistance may itself be criminal under federal law, in light of Rule 16-804(B) & (D) NMRA's prohibition of unlawful conduct that reflects adversely on the lawyer's fitness or that is prejudicial to the administration of justice." – Lawyers face the same co-conspirator and aider-and-abettor liabilities that potentially apply to other ancillary service providers. See Bruce E. Reinhart, supra p. 4, at 5, 7, 8-9. "Moreover, by accepting a payment of more than $10,000 that the lawyer knows came from a legal marijuana business, the lawyer is committing a federal money laundering crime ...." Id. at 9; cf. Exhibit D

(rescinding the Cole Memorandum and highlighting "the money laundering statutes"). Irrespective of whether the federal criminal statutes are ever enforced in this fashion, does their very existence threaten to ensnare lawyers under Rule 16-804 – a rule to which, in contrast with Rule 16-102, the supreme court has appended no additional commentary? The threat, if any, seems remote; having explicitly invited lawyers to assist clients in conduct permitted by the Compassionate Use Act, see Rule 16-102 cmt. 11, the supreme court surely wouldn't conclude that such assistance constitutes "a criminal act that adversely reflects on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects," Rule 16-804(B). But it's worth remembering that local federal courts needn't adopt New Mexico's Rules of Professional Conduct, let alone the commentary attached to them, in their entirety. See D.N.M.LR-Civ. 83.9. Indeed, the United States District Court for the District of Colorado opted out of a Colorado Supreme Court comment to Colorado's Rule 1.2 that was almost identical to New Mexico's, thereby re-exposing Colorado's federal practitioners to the disciplinary danger that the comment had sought to defuse. See Exhibit B, at 18 & n.2.

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Beyond the legal and ethical risks associated with representing medical marijuana businesses, there are practical risks. At least two bear mention here. First, professional-liability insurance policies sometimes include criminal-acts exclusions; attorneys contemplating this line of work should check their policies and obtain any necessary endorsements or other assurances. And second, fees paid by medical marijuana clients are subject to civil forfeiture. See Bruce E. Reinhart, supra p. 4, at 9.

Despite these risks – as the Committee acknowledged – "lawyers throughout the country, including New Mexico, are currently representing medical cannabis businesses in myriad ... ways." Exhibit B, at 17 n.1. Among them are brand-name law firms such as Dorsey & Whitney, Duane Morris, Fox Rothschild, Seyfarth Shaw, and Goodwin Procter. Follow them if you dare.

II. Other Recent Developments in Legal Ethics

A. Mandating social-media savvy

The supreme court approved a package of amendments to the official commentary underlying the Rules of Professional Conduct – effective December 31, 2017 – that are designed to drag older lawyers kicking and screaming into the Internet Age, and to remind younger lawyers that social-media mores may be incompatible with professional ethics. New comment 5 to Rule 16-101, for example, provides that in appropriate circumstances, "a lawyer should counsel the client about the client's use and maintenance of social media including the impact of privacy settings and the consequences of posting and removing content." A sentence added to comment 6 to Rule 16-106 reminds lawyers that "[s]ocial media communications and communications made on a lawyer's website or blog" are subject to the lawyer's duty to maintain the confidentiality of "information relating to the representation of a client." New comment 6 to Rule 16-305, adverting to contemporary methods of jury research, draws a line in the sand between viewing a prospective or sitting juror's "public social media profile and posts" (which is permissible) and "hav[ing] direct [social media] communication with the juror" (which isn't). See also, e.g., Rule 16-402 cmt. 5 NMRA ("A lawyer shall not contact, or direct or

authorize a nonlawyer assistant to contact, a represented person to seek access to the restricted portion of the person's social media profile unless provided an express authorization by the person's counsel."); Rule 16-403 cmt. 3 NMRA (providing that a lawyer or the lawyer's agent may ask an unrepresented person for access to the restricted portions of the person's social media, website, or profile, but only if the lawyer or agent "(1) uses a full name, (2) provides status as a lawyer or a nonlawyer assistant, ... (3) discloses the name of the client and the matter," and refrains from deception).

B. Regulating attorney-client arbitration agreements

Rule 16-108 addresses a variety of conflicts that may arise between lawyer and client. Paragraph (H)(1) of the rule concerns agreements to limit a lawyer's malpractice liability prospectively. Comment 14 makes clear that this paragraph doesn't prohibit a lawyer from conditioning representation on the client's agreement to arbitrate malpractice claims. But amendments to comment 14, effective December 31, 2017, state that the validity of such an agreement depends on the client's informed consent to it – consent that the lawyer can obtain only by explaining "that arbitration will constitute a waiver of important rights, including[] the right to a jury trial, potentially the right to broad discovery, and the right to an appeal on the merits."

C. The war on war stories: ABA Formal Opinions 479 and 480

Lawyers, on the whole, are social animals – and because they spend inordinate portions of their waking hours representing clients, their conversations with peers, friends, and family members tend to concern those professional experiences. The most discreet lawyers learn to purge war stories of identifying details, or to speak in hypotheticals. The least discreet drop the names of their most prominent clients with gusto.

The American Bar Association recently fired two shots across loose-lipped lawyers' bow. First, in a formal opinion entitled "The 'Generally Known' Exception to Former-Client Confidentiality," the ABA Standing Committee on Ethics and Professional Responsibility explored the meaning of the rule that prohibits lawyers from "us[ing] information relating to the representation [of a former client] to the disadvantage of the former client ... when the information has become generally known." Rule 16-109(C)(1) NMRA. The opinion declared that information is "generally known" only if it is "(a) widely recognized by members of the public in the relevant geographic area; or (b) widely recognized in the former client's industry, profession, or trade." ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 479, at 1 (2017) (attached hereto as Exhibit E). "Information is not 'generally known' simply because it has been discussed in open court, or is available in court records, in libraries, or in other public repositories of information." Id. Even more importantly, the "generally known" exception to confidentiality "applies ... only to the use, and not the disclosure or revelation, of former-client information." Id. And it has no application whatsoever to information about current clients. In short, Rule 16-106 means what it says: absent client consent or the limited circumstances identified in paragraph (B) of the rule, "[a] lawyer shall not reveal information relating to the representation of a client," Rule 16-106(A) NMRA, even if the information has become "generally known."

Nor is there any social-media exception to these principles. In Formal Opinion 480 – anticipated by our own supreme court's amendment of the commentary to the client-confidentiality rule, see Rule 16-106 cmt. 6 – the ABA Standing Committee wrote that "[l]awyers who blog or engage in other public commentary may not reveal information relating to a representation, including information contained in a public record." ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 480, at 1 (2018) (attached hereto as Exhibit F). The First Amendment, the Committee emphasized, did not call for a different conclusion. See id. at 4-5.

D. Confessing error: ABA Formal Opinion 481

The ABA's next formal opinion was calculated to make lawyers even more uncomfortable than the ABA's pronouncements about client confidentiality had already made them. In Formal Opinion 481, the Standing Committee concluded

> that a lawyer must inform a current client of a material error committed by the lawyer in the representation. An error is material if a disinterested lawyer would conclude that it is (a) reasonably likely to harm or prejudice a client; or (b) of such a nature that it would reasonably cause a client to consider terminating the representation even in the absence of harm or prejudice.

ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 481, at 4 (2018) (attached hereto as Exhibit G). The Standing Committee added that the required notification must be "prompt[] under the circumstances." Id. at 5. On the other hand, the Standing Committee concluded that lawyers have no duty to disclose material errors to former clients. See id. at 7-9.

E. Mastering disaster: ABA Formal Opinion 482

ABA Formal Opinion 482 addresses "a lawyer's ethical responsibilities (i) when a disaster threatens, and (ii) after a disaster occurs." ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482, at 2 (2018) (attached hereto as Exhibit H). Its bottom-line message is that lawyers must plan for disaster, because a disaster does not excuse lawyers from complying with their duties of competence, communication, and confidentiality. Thus, for example, the opinion recommends that a lawyer maintain easily accessible client lists, id. at 2-3; anticipate possible failures of power, mail delivery, and telephone service, id. at 3 n.7; plan for the unavailability of paper files, id. at 4; "ensure access to funds the lawyer is holding in trust," id. at 5; and devise a succession plan in the event of the lawyer's own death, id.

F. Data breach blues: ABA Formal Opinion 483

The ABA's most recent formal ethics opinion (at least at this writing) concerns lawyers' ethical duties pertaining to cybersecurity. See ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 483 (2018) (attached hereto as Exhibit I). The opinion concludes that – in addition to making reasonable efforts to safeguard clients' electronically stored information in the first place, see id. at 8-9 – lawyers "must make reasonable efforts to monitor their technology

resources to detect [data] breach[es]," id. at 5; "should consider proactively developing an incident response plan with specific plans and procedures for responding to a data breach," id. at 6; "[must] act reasonably and promptly to stop the breach and mitigate damage resulting from the breach," id.; "must make reasonable efforts to determine what occurred during the data breach," id. at 7; "[must make] accurate disclosure to [current] client[s] consistent with the lawyer's duty of communication and honesty," id.; and "are encouraged to adopt and follow a paper and electronic document retention schedule, which meets all applicable laws and rules, to reduce the amount of information relating to the representation of former clients that the lawyers retain," id. at 13.

16-102. Scope of representation and allocation of authority between client and lawyer.

A. **Client's decisions.** Subject to Paragraphs C and D of this rule, a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 16-104 NMRA of the Rules of Professional Conduct, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

B. **Representation not endorsement of client's views.** A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.

C. **Limitation of representation.** A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

D. **Course of conduct.** A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent or misleads the tribunal. A lawyer may, however, discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

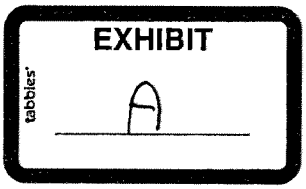
[As amended, effective March 15, 2001; as amended by Supreme Court Order No. 08-8300-029, effective November 3, 2008.]

Committee Commentary. —

Allocation of Authority between Client and Lawyer

[1] Paragraph A confers upon the client the ultimate authority to determine the purposes to be served by legal representation, within the limits imposed by law and the lawyer's professional obligations. The decisions specified in Paragraph A, such as whether to settle a civil matter, must also be made by the client. *See* Rule 16-104(A)(1) NMRA for the lawyer's duty to communicate with the client about such decisions. With respect to the means by which the client's objectives are to be pursued, the lawyer shall consult with the client as required by Rule 16-104(A)(2) NMRA and may take such action as is impliedly authorized to carry out the representation.

[2] On occasion, however, a lawyer and a client may disagree about the means to be used to accomplish the client's objectives. Clients normally defer to the special knowledge and skill of their lawyer with respect to the means to be used to accomplish their objectives, particularly with respect to technical, legal, and tactical matters. Conversely, lawyers usually defer to the client regarding questions about the expense to be incurred and concern for third persons who might be adversely affected. Because of the varied nature of the matters about which a lawyer and client might disagree and because the actions in question may implicate the interests of a tribunal or other persons, this rule does not prescribe how the disagreements are to be resolved. Other law, however, may be applicable and should be consulted by the



lawyer. The lawyer should also consult with the client and seek a mutually acceptable resolution of the disagreement. If the efforts are unavailing and the lawyer has a fundamental disagreement with the client, the lawyer may withdraw from the representation. *See* Rule 16-116(B)(4) NMRA. Conversely, the client may resolve the disagreement by discharging the lawyer. *See* Rule 16-116(A)(3) NMRA.

[3] At the outset of a representation, the client may authorize the lawyer to take specific action on the client's behalf without further consultation. Absent a material change in circumstances and subject to Rule 16-104 NMRA, a lawyer may rely on the advance authorization. The client may, however, revoke that authority at any time.

[4] In a case in which the client appears to be suffering diminished capacity, the lawyer's duty to abide by the client's decisions is to be guided by reference to Rule 16-114 NMRA.

Independence from Client's Views or Activities

[5] Legal representation should not be denied to people who are unable to afford legal services, or whose cause is controversial or the subject of popular disapproval. By the same token, representing a client does not constitute approval of the client's views or activities.

Agreements Limiting Scope of Representation

[6] The scope of services to be provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client. When a lawyer has been retained by an insurer to represent an insured, for example, the representation may be limited to matters related to the insurance coverage. A limited representation may be appropriate because the client has limited objectives for the representation. In addition, the terms upon which representation is undertaken may exclude specific means that might otherwise be used to accomplish the client's objectives. The limitations may exclude actions that the client thinks are too costly or that the lawyer regards as repugnant or imprudent.

[7] Although this rule affords the lawyer and client substantial latitude to limit the representation, the limitation must be reasonable under the circumstances. If, for example, a client's objective is limited to securing general information about the law the client needs in order to handle a common and typically uncomplicated legal problem, the lawyer and client may agree that the lawyer's services will be limited to a brief telephone consultation. Such a limitation, however, would not be reasonable if the time allotted was not sufficient to yield advice upon which the client could rely. Although an agreement for a limited representation does not exempt a lawyer from the duty to provide competent representation, the limitation is a factor to be considered when determining the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation. *See* Rule 16-101 NMRA.

[8] With regard to Paragraph C, limitations on the scope of representation may include drafting specific, discrete pleadings or other documents to be used in the course of representation without taking on the responsibility for drafting all documents needed to carry the representation to completion. For example, a lawyer may be retained by a client during the course of an appeal for the sole purpose of drafting a specific document, such as a docketing statement, memorandum in opposition, or brief. A lawyer who agrees to prepare a discrete document under a limited representation agreement must competently prepare that document and fully advise the client with respect to that document, which includes informing the client of any significant problems that may be associated with the limited representation arrangement. However, by agreeing to prepare a specific, discrete document the lawyer does not also assume the responsibility for taking later actions or preparing subsequent documents that may be necessary to continue to pursue the representation. While limitations on the scope of representation are permitted under this rule, the lawyer must explain the benefits and risks of such an

arrangement and obtain the client's informed consent to the limited representation. Upon expiration of the limited representation arrangement, the lawyer should advise the client of any impending deadlines, pending tasks, or other consequences flowing from the termination of the limited representation. *See* Rule 16-303 NMRA.

[9] All agreements concerning a lawyer's representation of a client must accord with the Rules of Professional Conduct and other law. *See, e.g.*, Rules 16-101, 16-108, and 16-506 NMRA.

[10] A lawyer providing limited-scope representation shall explain that other lawyers may communicate directly with the client, without the permission of the lawyer and outside the presence of the lawyer. The lawyer shall explain that the client may limit or halt communications with the other lawyer with notice, preferably in writing. The lawyer should explain the risks of communicating with another lawyer. The lawyer is not required to participate in communications outside the scope of the limited representation, even if the client requests such participation.

Criminal, Fraudulent, and Prohibited Transactions

[11] Paragraph D prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud. This prohibition, however, does not preclude the lawyer from giving an honest opinion about the actual consequences that appear likely to result from a client's conduct. Nor does the fact that a client uses advice in a course of action that is criminal or fraudulent of itself make a lawyer a party to the course of action. As an illustration, a lawyer may counsel or assist a client regarding conduct expressly permitted by the Lynn and Erin Compassionate Use Act, NMSA 1978, §§ 26-2B-1 to -7, and may assist a client in conduct that the lawyer reasonably believes is permitted by the Act. When that advice or assistance is given, the lawyer shall counsel the client about the potential legal consequences, under federal and other applicable law, of the client's proposed course of conduct. There is a critical distinction between presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity.

[12] When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is required to avoid assisting the client, for example, by drafting or delivering documents that the lawyer knows are fraudulent or by suggesting how the wrongdoing might be concealed. A lawyer may not continue assisting a client in conduct that the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent. The lawyer must, therefore, withdraw from the representation of the client in the matter. *See* Rule 16-116(A) NMRA. In some cases, withdrawal alone might be insufficient. It may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation, or the like. *See* Rule 16-401 NMRA.

[13] Where the client is a fiduciary, the lawyer may be charged with special obligations in dealings with a beneficiary.

[14] Paragraph D applies whether or not the defrauded party is a party to the transaction. Hence, a lawyer must not participate in a transaction to effectuate criminal or fraudulent avoidance of tax liability. Paragraph D does not preclude undertaking a criminal defense incident to a general retainer for legal services to a lawful enterprise. The last clause of Paragraph D recognizes that determining the validity or interpretation of a statute or regulation may require a course of action involving disobedience of the statute or regulation or of the interpretation placed upon it by governmental authorities.

[15] If a lawyer comes to know or reasonably should know that a client expects assistance not permitted by the Rules of Professional Conduct or other law or if the lawyer intends to act contrary to the client's instructions, the lawyer must consult with the client regarding the limitations on the lawyer's conduct. *See* Rule 16-104(A)(5) NMRA.

[Adopted by Supreme Court Order No. 08-8300-029, effective November 3, 2008; as amended by Supreme Court Order No. 15-8300-007, effective December 31, 2015; as amended by Supreme Court Order No. 17-8300-006, effective August 1, 2017.]

COMPILER'S AMENDMENT NOTES

The 2017 amendment, approved by Supreme Court Order No. 17-8300-006, effective August 1, 2017, made non-substantive language changes throughout the Committee commentary, and in Paragraph 11, added the illustration of a prohibited transaction.

The 2015 amendment, approved by Supreme Court Order No. 15-8300-007, effective December 31, 2015, revised the to provide for additional duties for lawyers providing limited-scope representation, and to make technical changes to rule citations; and in the , added Paragraph 10 and redesignated the subsequent paragraphs accordingly.

The 2008 amendment, approved by Supreme Court Order No. 08-8300-29, effective November 3, 2008, added "and allocation of authority between client and lawyer" in the title; in Paragraph A, added "Subject to Paragraphs C and D of this rule", added the reference to Rule 16-104 NMRA, and added the second sentence; in Paragraph D, changed "A lawyer shall not engage or counsel" to "A lawyer shall not counsel"; and deleted former Paragraph E which concerned consultation on limitations of assistance when the client expects assistance not permitted by the Rules of Professional Conduct.

The 2005 amendment of the Code of Professional Conduct Comment, effective January 20, 2005, added the comment to Paragraph E.

The 2001 amendment, effective March 15, 2001, rewrote Paragraph C which read "A lawyer may limit the objectives of the representation if the client consents after consultation".

COMPILER'S ANNOTATIONS

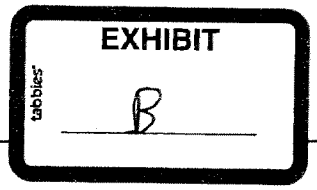
Unreasonable limitation on the scope of representation. — Where respondent agreed to represent a criminal defendant for the limited purpose of negotiating a plea agreement for a flat fee; respondent conducted no discovery or witness interviews; defendant rejected the state's plea offer; six weeks before trial, respondent sought to withdraw from the representation without discussing the matter with defendant; respondent cited a breakdown of the attorney-client relationship as the reason for the withdrawal, when in fact respondent wanted to withdraw because respondent had accepted a flat fee for negotiating a plea agreement; and after the court denied the motion, respondent told the prosecutor that respondent would not prepare for trial in order to set up a claim for ineffective assistance of counsel, respondent's conduct warranted suspension. *In re Chavez*, 2013-NMSC-008, 299 P.3d 403.

Duty to take essential steps and consult with client. — When one contracts with an attorney for legal services, it is not the client's responsibility to initiate all inquiries to the attorney to insure that essential steps are being taken. Furthermore, it is within the scope of an attorney's obligations to a client to provide the information, advice, and reassurances necessary to allay unnecessary concerns that the client may have. Where attorney does none of these things, he violates this and other rules. *In re Carrasco*, 1987-NMSC-089, 106 N.M. 294, 742 P.2d 506.

Attorney's failure to consult with his clients concerning the objectives of the representation and the

Ethics Advisory Opinion

From the State Bar of New Mexico's Ethics Advisory Committee



Formal Opinion: 2016-01

Topic: Lawyer's Ability to Represent Medical Cannabis Businesses

Rules Implicated: 16-102 NMRA (2015)

Disclaimer:
The Ethics Advisory Committee of the State Bar of New Mexico ("Committee") is constituted for the purpose of advising inquiring lawyers on the application of the New Mexico Rules of Professional Conduct in effect at the time the opinion is issued (the "Rules") to the specific facts as supplied by the inquiring lawyer or, in some instances, upon general issues facing members of the bar. The Committee does not investigate facts presented to it and generally assumes the facts presented are true and complete. The Committee does not render opinions on matters of substantive law. Lawyers are cautioned that should the Rules subsequently be revised or facts differ from those presented, a different conclusion may be reached by the Committee. The Committee's opinions are advisory only, and are not binding on the inquiring lawyer, the disciplinary board, or any tribunal. The statements expressed in this opinion are the consensus of the Committee members who considered the issue.

Question Presented:
Can a New Mexico lawyer comply with the Rules of Professional Conduct in representing non-profit producers, courier and manufacturers of medical cannabis and approved laboratories?

Summary Answer:
Yes, but a lawyer may not counsel or "assist" a client to commit a crime.

Analysis:
The issue before the Committee was whether a law firm can represent non-profit producers, couriers and manufacturers of medical cannabis and approved laboratories. This presented a novel question to the Committee. It involves issues of federalism, public policy and the meaning of "assistance" under rule 16-102(D) NMRA. As other states have dealt with this issue and the Committee conducted a thorough review of opinions on the subject[1].

The Committee is in agreement, as are all of the related opinions available, that a lawyer may "represent" a medical cannabis business in so far as to advise it on the legality of its proposed activities. This is squarely covered under our Rule 16-102(D):

> D. Course of conduct. A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent or misleads the tribunal. *A lawyer may, however, discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.* (emphasis added)

What is much less clear is whether a lawyer can actually "represent" such a business for substantive business-related purposes, such as creating an LLC, negotiating contracts, or other possible tax and business representation. The Committee is in agreement that this determination rests within the same section of the Rule, specifically the language admonishing a lawyer from "counsel[ing] a client to engage, or assist[ing] a client in conduct that the lawyer knows is criminal." *Id.* As producing and distributing any type of cannabis, including medical cannabis permitted under state laws, is illegal under federal law, 21 U.S.C. § 841(a)(1), a lawyer may not provide prohibited counseling or assistance.

The Committee looked at several jurisdictions in its analysis and notes that the Arizona State Bar Committee on the Rules of Professional conduct came to a different conclusion. However, in the Committee's opinion, that opinion is based on a value judgment of the current state of federal laws and prosecutions and not on a true reading of the Rules of Professional Conduct. The Arizona Committee seems to add what this Committee feels are irrelevant factors (3) and (4) to the analysis, when it based its conclusion on the fact that:

> [N]o prior Arizona ethics opinions or cases have addressed the novel issue presented by the adoption of the Act — whether a lawyer may ethically "counsel" or "assist" a client under the following conditions: (1) the client's conduct complies with a state statute expressly authorizing the conduct at issue; (2) the conduct may nonetheless violate federal law; (3) the federal government has issued a formal "memorandum" that essentially carves out a safe harbor for conduct that is in "clear and unambiguous compliance" with state law, at least so long as other factors are not present (such as unlawful firearm use, or "for profit" commercial sales); and (4) no court opinion has held that the state law is invalid or unenforceable on federal preemption grounds.

While the Committee understands Arizona's desire to allow this type of representation, it does not feel that factors (3) and (4) overcome the fundamental fact of illegality under current federal law. Similarly, the Illinois State Bar came up with this seemingly inconsistent conclusion:

> The negotiation of contracts and the drafting of legal documents for such a client are means of assisting the client in establishing a medical marijuana business. Therefore, an attorney who performs such work would be assisting the client in conduct that violates federal criminal law, even though such conduct is permissible under the new state law. But as quoted above, a lawyer may provide such assistance if the lawyer is assisting the "client to make a good-faith effort to determine the validity, scope, meaning or application of the law."

> As Preamble [14] notes, "The Rules of Professional Conduct are rules of reason. They should be interpreted with reference to the purposes of legal representation and of the law itself." The Committee believes that it is reasonable to permit Illinois lawyers, whose expertise in draftsmanship and negotiations is of great value to the public, to provide the same services to medical marijuana clients that they provide to other businesses. One of the purposes of legal representation is to enable clients to engage in legally regulated businesses efficiently, and that purpose is advanced by their retention of counsel to handle matters that require legal expertise. A lawyer who concludes that a client's conduct complies with state law in a manner consistent with the application of federal criminal law may provide ancillary services to assure that the client continues to do so. Illinois Professional Conduct Advisory Opinion 14-07 (October, 2014)

The Committee is in agreement that the more accurate position, which comports with our Rule 16-102, is clearly stated in Maine's Opinion:

> Maine and its sister states may well be in the vanguard regarding the medicinal use and effectiveness of marijuana. However, *the Rule which governs attorney conduct does not make a distinction between crimes which are enforced and those which are not.* So long as both the federal law and the language of the Rule each remain the same, an attorney needs to perform the analysis required by the Rule and determine whether the particular legal service being requested rises to the level of assistance in violating federal law. Maine Board of Overseers of the Bar, Professional Ethics Commission Opinion #199 (2010) (emphasis added). *See also* Connecticut Bar Association Professional Ethics Committee, Informal Opinion 2013-02 (same).

The Colorado Bar Association Ethics Committee, in a formal opinion, encapsulated the inherent tensions, but also sided with the letter of the Rules of Professional Conduct:

> Public policy considerations favor lawyers providing the full range of legal advice authorized under Colo. RPC 2.1 so that their clients may comply with Colorado's marijuana use laws. "[I]t too often is overlooked that the lawyer and the law office are indispensable parts of our administration of justice. Law-abiding people can go nowhere else to learn the ever changing and constantly multiplying rules by which they must behave and to obtain redress for their wrongs." *Hickman v. Taylor*, 329 U.S. 495, 514 (U.S. 1947) (Jackson, J., concurring). Nevertheless, unless and until there is a change in applicable federal law or in the Colorado Rules of Professional Conduct, a lawyer cannot advise a client regarding the full panoply of conduct permitted by the marijuana amendments to the Colorado Constitution and implementing statutes and regulations. To the extent that advice were to cross from advising or representing a client regarding the consequences of a client's past or contemplated conduct under federal and state law to counseling the client to engage, or assisting the client, in conduct the lawyer knows is criminal under federal law, the lawyer would violate Rule 1.2(d). Formal Opinion 125 (2013). *See also* Disciplinary Board of Hawai'i Supreme Court Formal Opinion 49 (2015)(same).

Of note, after the ethics opinion cited above, the Supreme Court of Colorado added a comment to its rule permitting lawyers to "assist a client in conduct that the lawyer reasonably believes is permitted [under state law]," and directs that the lawyer "shall also advise the client regarding related federal law and policy." Colo. RPC 1.2 (2012), Comment 14[2]. Similarly, the Connecticut Superior Court amended its Rules on July 1, 2014, adding that lawyers may "counsel or assist a client regarding conduct expressly permitted by Connecticut law, provided that the lawyer counsels the client about the legal consequences, under other applicable law, of the client's proposed course of conduct." Connecticut Rule of Professional Conduct 1.2(d), explaining in the Commentary that this change "is intended to permit counsel to provide legal services to clients without being subject to discipline under these Rules notwithstanding that the services concern conduct prohibited under federal or other law but expressly permitted under Connecticut law, e.g., conduct under An Act Concerning the Palliative Use of Marijuana, Public Act 12-55, effective Oct. 1, 2012." *Id.*

The Committee agrees with the Maine and Colorado opinions that assistance to these medical cannabis businesses would violate the Rules of Professional Conduct as currently written. The Committee has also determined that attorneys with multiple licenses or on inactive status in New Mexico are equally subject to our Rules of Professional Conduct for activities conducted in other jurisdictions. Therefore, the Committee cautions New Mexico attorneys representing medical cannabis businesses in states that may specifically permit such representation under their rules that this does not alter the lawyer's responsibilities under our Rules of Professional Conduct.

The Committee is unable to agree as to the exact parameters of "assistance." At one end of the spectrum, the Committee is in general agreement that negotiating contracts for the purchase of cannabis would be directly assisting the client to engage in a criminal activity. At the other end of the spectrum, some Committee members opined that forming a general alternative medical business, which *could possibly* include the prescribing and distributing of medical cannabis would not be such assistance. However, even with this example some Committee members felt there was impermissible assistance. Overall, the Committee feels that attorneys must analyze the issue of "assistance" for themselves, based upon the specific facts of the situation, bearing in mind that that line may be tested through a disciplinary complaint.

Conclusion: A New Mexico lawyer may represent non-profit producers, courier and manufacturers of medical cannabis and approved laboratories, to the extent that representation is not in the form of impermissible counseling to engage in or providing "assistance" in the commission of crimes.

Endnotes

1 The Committee has also taken note of two facts, though determined neither is dispositive to the question presented. Those facts are: 1) The New Mexico Supreme Court recently declined to adopt proposed Rule 16-102(E) which expressly permitted a lawyer to "counsel or assist a client regarding conduct expressly permitted by the [Medical Cannabis Act], ¶¶26-2B-1-7 NMSA"; and 2) lawyers throughout the country, including New Mexico, are currently representing medical cannabis businesses in myriad of ways.

2 Of further note, the U.S. District Court for Colorado declined to adopt this new comment to the rule, specifically excluding it except as to permit practitioners in the U.S. District Court to advise clients regarding the "validity, scope and meaning" of Colorado's marijuana laws. Local Rule D.C.COLO.LAttyR 2(b)(2) (Dec. 1, 2015). This federal local rule created a significant split in the ethical rules applicable to state and federal practitioners in Colorado.

STATE BAR OF NEW MEXICO
ETHICS ADVISORY COMMITTEE
INFORMAL ETHICS ADVISORY OPINION

INFORMAL OPINION: 2017-013

DATE: April 17, 2018

TOPIC: Attorney assistance to medical cannabis businesses

RULES IMPLICATED: 16-102(D) & 16-804 NMRA.

DISCLAIMER: The Ethics Advisory Committee of the State Bar of New Mexico ("Committee") is constituted for the purpose of advising inquiring lawyers on the application of the New Mexico Rules of Professional Conduct in effect at the time the opinion is issued ("Rules") to the specific facts as supplied by the inquiring lawyer. The Committee does not investigate the facts supplied by the lawyer and they are assumed to be accurate and complete. The Committee does not render opinions on matters of substantive law. Lawyers are cautioned that should the Rules subsequently be revised or different facts be presented, a different conclusion may be appropriate. The Committee's opinions are advisory only, and are not binding on the inquiring lawyer, the disciplinary board, or any tribunal. The statements expressed in this opinion are the consensus of the Committee members who considered the request.

QUESTION PRESENTED:

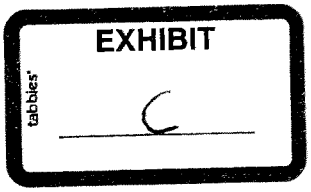
In light of the New Mexico Supreme Court's amended commentary to Rule 16-102 NMRA, what is the scope of assistance that an attorney may provide within the bounds of the Rules of Professional Conduct to a medical cannabis business operating under the Lynn and Erin Compassionate Use Act?

SHORT ANSWER:

Attorneys may provide the ordinary legal services to medical cannabis businesses operating under the Compassionate Use Act that they typically provide to other businesses. In providing legal services to medical cannabis businesses, attorneys must advise their clients on the potential consequences of their conduct under federal law, and should also review the lawfulness of their own conduct under federal law so as to ensure that they stay in compliance with Rule 16-804 NMRA.

FACTUAL BACKGROUND:

In Formal Opinion 2016-01 (withdrawn), the Committee provided an opinion regarding whether an attorney could provide legal services to businesses engaged in the medical cannabis trade under New Mexico's Rules of Professional Conduct. In 2017, the New Mexico Supreme Court amended its commentary to Rule 16-102 NMRA. The Committee later withdrew Formal



Opinion 2016-01.[1] The inquiring lawyer would like to know, in light of the amended commentary, the scope of permissible assistance that attorneys may provide to medical cannabis businesses under the Rules of Professional Conduct.

ANALYSIS:

1. Background: Short Summary of Formal Opinion 2016-01

Because the Committee has withdrawn Formal Opinion 2016-01, we will provide a brief summary of our advice in that opinion. The Committee believes that this background is useful in order to provide context for the current opinion and the Supreme Court's recent rulemaking activity in the area.

In Formal Opinion 2016-01 (withdrawn), this Committee interpreted Rule 16-102(D) NMRA, which states: "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal. . . . A lawyer may, however, discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning, or application of the law." In that opinion, this Committee concluded that conducting a medical cannabis business, even if legal under state law, was still illegal under federal law. We arrived at that opinion even though, at the time, the U.S. Department of Justice had written policies de-prioritizing the prosecution of cannabis-related offenses against businesses that were engaged in activities that were lawful under state and tribal law (the "Cole Memorandum" and the "Wilkinson Memorandum", respectively).[2]

Because medical cannabis businesses engage in activity that violates federal criminal law, we reasoned that, under the plain meaning of Rule 16-102(D) NMRA, most legal services to medical cannabis businesses (aside from merely providing advice as to the legality of their conduct) would qualify as "assisting" a client to engage in illegal conduct. Thus, lawyers would be barred from providing most legal services to the extent that those legal services constituted "assistance" to the medical cannabis businesses.

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[1] The Committee withdrew the opinion in part because of the commentary, and also because, upon further review, the Committee concluded that some of the language in that opinion was not precisely correct when it stated that a Colorado comment to its RPC 1.2 "permitt[ed]" lawyers to assist clients in conduct permitted under state law. In fact, the comment itself did not change the rule, and thus did not itself change what conduct was permitted; instead, it provided a new interpretation of the rule. While this is a subtle difference, we note it because, as explained in the Scope of the Rules, to the extent a future court perceives a conflict between the rule and the comment, the rule is authoritative. In addition, the Committee generally does not opine on the effect of rule and commentary changes of other states.

[2] Subsequently, the Department of Justice rescinded the Cole and Wilkinson Memoranda. Thus, medical marijuana businesses in New Mexico currently have no guarantee against prosecution under federal law.

2. Post-Opinion Developments: Supreme Court Amends Commentary to Rule 16-102 NMRA

Following the publication of Formal Opinion 2016-01, the Supreme Court conducted an out-of-cycle amendment to the committee commentary to Rule 16-102 NMRA. The Supreme Court did not amend the Rule itself. The amended commentary reads as follows [new material in bolded italics]:

> 11. Paragraph D prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud. This prohibition, however, does not preclude the lawyer from giving an honest opinion about the actual consequences that appear likely to result from a client's conduct. Nor does the fact that a client uses advice in a course of action that is criminal or fraudulent of itself make a lawyer a party to the course of action. ***As an illustration, a lawyer may counsel or assist a client regarding conduct expressly permitted by the Lynn and Erin Compassionate Use Act, NMSA 1978, §§ 26-2B-1 to 7, and may assist a client in conduct that the lawyer reasonably believes is permitted by the Act. When that advice or assistance is given, the lawyer shall counsel the client about the potential legal consequences, under federal and other applicable law, of the client's proposed course of conduct.*** There is a critical distinction between presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity.

For the reasons explained in Footnote 1, the Committee later withdrew Formal Opinion 2016-01.

3. Scope of Permissible Activity in Light of New Commentary

The inquiring lawyer has asked this Committee, in light of the new commentary, about the scope of permissible assistance that attorneys may provide to businesses engaged in medical cannabis activities permitted under state law.

In Formal Opinion 16-01 (withdrawn), we surveyed other ethics opinions that had interpreted rules similar to Rule 16-102(D) (NMRA), and declined to follow those jurisdictions that allowed for the provision of legal services to medical cannabis businesses, in part because their opinions were not grounded in the plain language of the Rules. While those opinions cited laudable policy reasons for allowing medical cannabis businesses to have access to legal services, this Committee does not set policy for the State's legal system. Instead, that is the role of the Supreme Court. *Ammerman v. Hubbard Broadcasting, Inc.*, 1976-NMSC-031, ¶¶ 15–16, 89 N.M. 307. Without any indication that the Supreme Court would do anything other than give the words in Rule 16-102(D) NMRA their ordinary meaning, this Committee concluded, when it drafted Formal Opinion 16-01, that it could not advise attorneys that they would be acting within the Rules if they assisted clients whose conduct the attorneys knew would violate federal criminal law.

Now, the Supreme Court has provided some additional guidance on the question. Some other states, faced with similar issues, have chosen to amend the text of the rule. *See, e.g.*, Ohio

Rule of Professional Conduct 1.2(d) (as amended September 20, 2016). The New Mexico Supreme Court, however, chose to amend the commentary to the rule, and not the rule itself. We note that the "Scope" of New Mexico's Rules of Professional Conduct, which itself was promulgated by the Supreme Court, explains that the "committee commentary accompanying each rule explains and illustrates the meaning and purpose of the rule. The Preamble and Scope provide general orientation. ***The commentaries are intended as guides to interpretation, but the text of each rule is authoritative.***" (emphasis added). Thus, to the extent that there is any conflict between the commentary and the text of the rule, the text of the rule trumps the commentary.[3]

Nonetheless, the Committee does not believe that the Supreme Court would have added committee commentary if it believed the commentary conflicted with the text of the rule. Instead, as explained in the Scope of the Rules, the committee commentary is intended to be a guide to the interpretation of the Rules. Thus, while the amendment to the committee commentary does not itself alter the rule, it provides guidance from the Supreme Court as to how to interpret the Rule.

The commentary now states that lawyers may assist clients regarding conduct that is expressly permitted under the Compassionate Use Act. The Committee interprets the commentary to mean attorneys may assist medical cannabis entities with ordinary legal services that law firms typically provide to businesses and non-profit corporations, such as assistance with business formation and the drafting of contracts without facing disciplinary action. But because the language of the Rule is unchanged, and the commentary has not specifically provided additional guidance as to the meaning of "assist" or "criminal," the Committee cautions attorneys not to take the amended commentary as a broad license to assist clients in other conduct that may be illegal under state or federal law that is not expressly covered by the Compassionate Use Act. For similar reasons, attorneys should be cautious about providing assistance that goes beyond the ordinary legal services that law firms typically provided to businesses and non-profit corporations. Attorneys should also consider whether their assistance may itself be criminal under federal law, in light of Rule 16-804(B) & (D) NMRA's prohibition of unlawful conduct that reflects adversely on the lawyer's fitness or that is prejudicial to the administration of justice.

In addition, the commentary makes clear that, when providing legal services to medical cannabis businesses, attorneys must "counsel the client about the potential legal consequences, under federal and other applicable law, of the client's proposed course of conduct."

CONCLUSION:

The Supreme Court's new commentary to Rule 16-102(D) NMRA indicates that the Rule should be interpreted not to prohibit attorneys from providing businesses operating under the Compassionate Use Act the same ordinary legal services that they typically provide to other

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[3] Thus, as stated in Footnote 1, supra, the Committee acknowledges that its language was not precisely correct in Formal Opinion 2016-01 (withdrawn) when it noted that a Colorado comment to its RPC 1.2 "permitt[ed]" lawyers to assist clients in conduct permitted under state law.

businesses. Because of the unique nature of the amendment to the commentary, however, attorneys should not assume that Rule 16-102(D) allows attorneys to assist clients in any other conduct not covered by the Compassionate Use Act that is unlawful under the state or federal law. If attorneys provide legal services to medical cannabis businesses, they must counsel their clients about the potential legal consequences of the client's proposed course of conduct. Attorneys should also assess the lawfulness of their own conduct under federal law to ensure that they do not violate Rule 16-804(B) or (D) NMRA.

Office of the Attorney General
Washington, D. C. 20530

January 4, 2018

MEMORANDUM FOR ALL UNITED STATES ATTORNEYS

FROM: Jefferson B. Sessions, III
Attorney General

SUBJECT: Marijuana Enforcement

In the Controlled Substances Act, Congress has generally prohibited the cultivation, distribution, and possession of marijuana. 21 U.S.C. § 801 *et seq*. It has established significant penalties for these crimes. 21 U.S.C. § 841 *et seq*. These activities also may serve as the basis for the prosecution of other crimes, such as those prohibited by the money laundering statutes, the unlicensed money transmitter statute, and the Bank Secrecy Act. 18 U.S.C. §§ 1956-57, 1960; 31 U.S.C. § 5318. These statutes reflect Congress's determination that marijuana is a dangerous drug and that marijuana activity is a serious crime.

In deciding which marijuana activities to prosecute under these laws with the Department's finite resources, prosecutors should follow the well-established principles that govern all federal prosecutions. Attorney General Benjamin Civiletti originally set forth these principles in 1980, and they have been refined over time, as reflected in chapter 9-27.000 of the U.S. Attorneys' Manual. These principles require federal prosecutors deciding which cases to prosecute to weigh all relevant considerations, including federal law enforcement priorities set by the Attorney General, the seriousness of the crime, the deterrent effect of criminal prosecution, and the cumulative impact of particular crimes on the community.

Given the Department's well-established general principles, previous nationwide guidance specific to marijuana enforcement is unnecessary and is rescinded, effective immediately.[1] This memorandum is intended solely as a guide to the exercise of investigative and prosecutorial discretion in accordance with all applicable laws, regulations, and appropriations. It is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.

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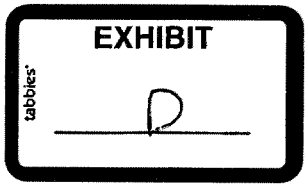
[1] Previous guidance includes: David W. Ogden, Deputy Att'y Gen., Memorandum for Selected United States Attorneys: Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana (Oct. 19, 2009); James M. Cole, Deputy Att'y Gen., Memorandum for United States Attorneys: Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (June 29, 2011); James M. Cole, Deputy Att'y Gen., Memorandum for All United States Attorneys: Guidance Regarding Marijuana Enforcement (Aug. 29, 2013); James M. Cole, Deputy Att'y Gen., Memorandum for All United States Attorneys: Guidance Regarding Marijuana Related Financial Crimes (Feb. 14, 2014); and Monty Wilkinson, Director of the Executive Office for U.S. Att'ys, Policy Statement Regarding Marijuana Issues in Indian Country (Oct. 28, 2014).



AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 479 **December 15, 2017**

The "Generally Known" Exception to Former-Client Confidentiality

A lawyer's duty of confidentiality extends to former clients. Under Model Rule of Professional Conduct 1.9(c), a lawyer may not use information relating to the representation of a former client to the former client's disadvantage without informed consent, or except as otherwise permitted or required by the Rules of Professional Conduct, unless the information has become "generally known."

The "generally known" exception to the duty of former-client confidentiality is limited. It applies (1) only to the use, and not the disclosure or revelation, of former-client information; and (2) only if the information has become (a) widely recognized by members of the public in the relevant geographic area; or (b) widely recognized in the former client's industry, profession, or trade. Information is not "generally known" simply because it has been discussed in open court, or is available in court records, in libraries, or in other public repositories of information.

Introduction

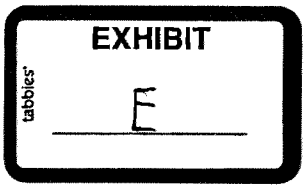
Confidentiality is essential to the attorney-client relationship. The duty to protect the confidentiality of client information has been enforced in rules governing lawyers since the Canons of Ethics were adopted in 1908.

The focus of this opinion is a lawyer's duty of confidentiality to former clients under Model Rule of Professional Conduct 1.9(c). More particularly, this opinion explains when information relating to the representation of a former client has become generally known, such that the lawyer may use it to the disadvantage of the former client without violating Model Rule 1.9(c)(1).

The Relevant Model Rules of Professional Conduct

Model Rule 1.6(a) prohibits a lawyer from revealing information related to a client's representation unless the client gives informed consent, the disclosure is impliedly authorized to carry out the representation, or the disclosure is permitted by Model Rule 1.6(b).[1] Model Rule 1.9 extends lawyers' duty of confidentiality to former clients. Model Rules 1.9(a) and (b) govern situations in which a lawyer's knowledge of a former client's confidential information would create a conflict of interest in a subsequent representation. Model Rule 1.9(c) "separately regulates the use and disclosure of confidential information" regardless of "whether or not a subsequent

[1] MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2017) [hereinafter MODEL RULES].



representation is involved."[2]

Model Rule 1.9(c)(2) governs the *revelation* of former client confidential information. Under Model Rule 1.9(c)(2), a lawyer who formerly represented a client in a matter, or whose present or former firm formerly represented a client in a matter, may not reveal information relating to the representation except as the Model Rules "would permit or require with respect to a [current] client." Lawyers thus have the same duties not to *reveal* former client confidences under Model Rule 1.9(c)(2) as they have with regard to current clients under Model Rule 1.6.

In contrast, Model Rule 1.9(c)(1) addresses the *use* of former client confidential information. Model Rule 1.9(c)(1) provides that a lawyer shall not use information relating to a former client's representation "to the disadvantage of the former client except as [the Model] Rules would permit or require with respect to a [current] client, or when the information has become *generally known*."[3] The terms "reveal" or "disclose" on the one hand and "use" on the other describe different activities or types of conduct even though they may—but need not—occur at the same time. The generally known exception applies only to the "use" of former client confidential information. This opinion provides guidance on when information is generally known within the meaning of Model Rule 1.9(c)(1).[4]

The Generally Known Exception

The generally known exception to the use of former-client information was introduced in the 1983 Model Rules.[5] The term is not defined in Model Rule 1.0 or in official Comments to Model Rule 1.9. A number of courts and other authorities conclude that information is *not* generally known merely because it is publicly available or might qualify as a public record or as a matter of public record.[6] Agreement on when information *is* generally known has been harder to achieve.

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[2] ELLEN J. BENNETT ET AL., ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 190 (8th ed. 2015).

[3] MODEL RULES R. 1.9(c)(1) (2017) (emphasis added).

[4] *See id.* at cmt. 9 (explaining that "[t]he provisions of this Rule are for the protection of former clients and can be waived if the client gives informed consent").

[5] *See* RONALD D. ROTUNDA & JOHN S. DZIENKOWSKI, LEGAL ETHICS: THE LAWYER'S DESKBOOK ON PROFESSIONAL RESPONSIBILITY § 1.9, at 534 (2017–2018) (explaining that the language was originally part of Model Rule 1.9(b), and was moved to Model Rule 1.9(c) in 1989).

[6] *See, e.g.*, Pallon v. Roggio, Civ. A. Nos. 04-3625(JAP), 06-1068(FLW), 2006 WL 2466854, at *7 (D. N.J. Aug. 24, 2006) ("'Generally known' does not only mean that the information is of public record. . . . The information must be within the basic understanding and knowledge of the public. The content of form pleadings, interrogatories and other discovery materials, as well as general litigation techniques that were widely available to the public through the internet or another source, such as continuing legal education classes, does not make that information 'generally known' within the meaning of Rule 1.9(c)." (citations omitted)); Steel v. Gen. Motors Corp., 912 F. Supp. 724, 739 (D. N.J. 1995) (in a discussion of Rule 1.9(c)(2), stating that the fact that information is publicly available does not make it 'generally known'); *In re* Gordon Props., LLC, 505 B.R. 703, 707 n.6 (Bankr. E.D. Va. 2013) ("'Generally known' does not mean information that someone can find."); *In re* Anonymous, 932 N.E.2d 671, 674 (Ind. 2010) (stating in connection with a discussion of Rule 1.9(c)(2) that "the Rules contain no exception allowing revelation of information relating to a representation even if a diligent researcher could unearth it through public sources" (footnote omitted); *In re* Tennant, 392 P.3d 143, 148 (Mont. 2017) (explaining that with respect to the Rule 1.9(c) analysis of

A leading dictionary suggests that information is generally known when it is "popularly" or "widely" known.[7] Commentators have essentially endorsed this understanding of generally known by analogizing to an original comment in New York's version of Rule 1.6(a) governing the protection of a client's confidential information. The original comment distinguished "generally known" from "publicly available."[8] Commentators find this construct "a good and valid guide"[9] to when information is generally known for Rule 1.9(c)(1) purposes:

> [T]he phrase "generally known" means much more than publicly available or accessible. It means that the information has already received widespread publicity. For example, a lawyer working on a merger with a Fortune 500 company could not whisper a word about it during the pre-offer stages, but once the offer is made—for example, once AOL and Time Warner have announced their merger, and the Wall Street Journal has reported it on the

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when information is considered to be generally known, the fact that "the information at issue is generally available does not suffice; the information must be within the basic knowledge and understanding of the public;" protection of the client's information "'is not nullified by the fact that the circumstances to be disclosed are part of a public record, or that there are other available sources for such information, or by the fact that the lawyer received the same information from other sources'") (citations omitted)); Turner v. Commonwealth, 726 S.E.2d 325, 333 (Va. 2012) (Lemons, J., concurring) ("While testimony in a court proceeding may become a matter of public record even in a court denominated as a 'court not of record,' and may have been within the knowledge of anyone at the preliminary hearing, it does not mean that such testimony is 'generally known.' There is a significant difference between something being a public record and it also being 'generally known.'"); N.Y. State Bar Ass'n Comm. on Prof'l Ethics Op. 1125, 2017 WL 2639716, at *1 (2017) (discussing lawyers' duty of confidentiality and stating that "information is not 'generally known' simply because it is in the public domain or available in a public file" (reference omitted)); Tex. Comm. on Prof'l Ethics Op. 595, 2010 WL 2480777, at *1 (2010) ("Information that is a matter of public record may not be information that is 'generally known.' A matter may be of public record simply by being included in a government record . . . whether or not there is any general public awareness of the matter. Information that 'has become generally known' is information that is actually known to some members of the general public and is not merely available to be known if members of the general public choose to look where the information is to be found."); ROTUNDA & DZIENKOWSKI, *supra* note 5, § 1.9-3, at 554 (stating that Model Rule 1.9 "deals with what has become generally known, not what is publicly available if you know exactly where to look"); *see also* Dougherty v. Pepper Hamilton LLP, 133 A.3d 792, 800 (Pa. Super. Ct. 2016) (questioning whether an FBI affidavit that was accidentally attached to a document in an unrelated proceeding and was thus publicly available through PACER was "actually 'generally known,'" since "a person interested in the FBI affidavit 'could obtain it only by means of special knowledge'" (citing Restatement (Third) of the Law Governing Lawyers § 59, cmt. d). *But see* State v. Mark, 231 P.3d 478, 511 (Haw. 2010) (treating a former client's criminal conviction as "generally known" when discussing a former client conflict and whether matters were related); Jamaica Pub. Serv. Co. v. AIU Ins. Co., 707 N.E.2d 414, 417 (N.Y. 1998) (applying former DR 5-108(a)(2) and stating that because information regarding the defendant's relationship with its sister companies "was readily available in such public materials as trade periodicals and filings with State and Federal regulators," it was "generally known"); State ex rel. Youngblood v. Sanders, 575 S.E.2d 864, 872 (W. Va. 2002) (stating that because information was contained in police reports it was "generally known" for Rule 1.9 purposes); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 59 cmt. d (2000) ("Information contained in books or records in public libraries, public-record depositories such as government offices, or publicly accessible electronic-data storage is generally known if the particular information is obtainable through publicly available indexes and similar methods of access.").

[7] THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 732 (4th ed. 2009).

[8] *See* ROY D. SIMON & NICOLE HYLAND, SIMON'S NEW YORK RULES OF PROFESSIONAL CONDUCT ANNOTATED 685 (2017) (discussing former comment 4A to New York Rule 1.6).

[9] *Id.*

> front page, and the client has become a former client—then the lawyer may tell the world. After all, most of the world already knows. . . .
>
> [O]nly if an event gained considerable public notoriety should information about it ordinarily be considered "generally known."[10]

Similarly, in discussing confidentiality issues under Rules 1.6 and 1.9, the New York State Bar Association's Committee on Professional Ethics ("NYSBA Committee") opined that "information is generally known only if it is known to a sizeable percentage of people in 'the local community or in the trade, field or profession to which the information relates.'"[11] By contrast, "[I]nformation is not 'generally known' simply because it is in the public domain or available in a public file."[12] The Illinois State Bar Association likewise reasoned that information is generally known within the meaning of Rule 1.9 if it constitutes "'common knowledge in the community.'"[13]

As the NYSBA Committee concluded, information should be treated differently if it is widely recognized in a client's industry, trade, or profession even if it is not known to the public at large. For example, under Massachusetts Rule of Professional Conduct 1.6(a), a lawyer generally is obligated to protect "confidential information relating to the representation of a client."[14] Confidential information, however, does not ordinarily include "information that is generally known in the local community or in the trade, field or profession to which the information relates."[15] Similarly, under New York Rule of Professional Conduct 1.6(a), a lawyer generally cannot "knowingly reveal confidential information . . . or use such information to the disadvantage of a client or for the advantage of the lawyer or a third person,"[16] but "confidential information" does not include "information that is generally known in the local community or in the trade, field or profession to which the information relates."[17] Returning to Model Rule 1.9(c)(1), allowing information that is generally known in the former client's industry, profession, or trade to be used pursuant to Model Rule 1.9(c)(1) makes sense if, as some scholars have urged, the drafters of the rule contemplated that situation.[18]

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[10] *Id.*

[11] N.Y. State Bar Ass'n, Comm. on Prof'l Ethics, Op. 991, at ¶ 20 (2013).

[12] *Id.* at ¶ 17.

[13] Ill. State Bar Ass'n. Advisory Op. 05-01, 2006 WL 4584283, at *3 (2006) (quoting RESTATEMENT (SECOND) OF AGENCY § 395 cmt. b (1958)). The Illinois State Bar borrowed this definition from section 395 of the Restatement (Second) of Agency, which excludes such information from confidential information belonging to a principal that an agent may not use "in violation of his duties as agent, in competition with or to the injury of the principal," whether "on his own account or on behalf of another." RESTATEMENT (SECOND) OF AGENCY § 395 & cmt. b (1958).

[14] MASS. RULES OF PROF'L CONDUCT R. 1.6(a) (2017).

[15] *Id.* at cmt. 3A.

[16] N.Y. RULES OF PROF'L CONDUCT R. 1.6(a) (2017).

[17] *Id.* at cmt. [4A] ("Information is generally known in the local community or in the trade, field or profession to which the information relates is also not protected, unless the client and the lawyer have otherwise agreed. Information is not 'generally known' simply because it is in the public domain or available in a public file").

[18] *See* GEOFFREY C. HAZARD, JR. ET AL., THE LAW OF LAWYERING § 14.16, at 14-48 (2016) (discussing generally known and saying, "It seems likely that both the Kutak Commission and the Ethics 2000 Commission . . .

A Workable Definition of Generally Known under Model Rule 1.9(c)(1)

Consistent with the foregoing, the Committee's view is that information is generally known within the meaning of Model Rule 1.9(c)(1) if (a) it is widely recognized by members of the public in the relevant geographic area; or (b) it is widely recognized in the former client's industry, profession, or trade. Information may become widely recognized and thus generally known as a result of publicity through traditional media sources, such as newspapers, magazines, radio, or television; through publication on internet web sites; or through social media. With respect to category (b), information should be treated as generally known if it is announced, discussed, or identified in what reasonable members of the industry, profession, or trade would consider a leading print or online publication or other resource in the particular field. Information may be widely recognized within a former client's industry, profession, or trade without being widely recognized by the public. For example, if a former client is in the insurance industry, information about the former client that is widely recognized by others in the insurance industry should be considered generally known within the meaning of Model Rule 1.9(c)(1) even if the public at large is unaware of the information.

Unless information has become widely recognized by the public (for example by having achieved public notoriety), or within the former client's industry, profession, or trade, the fact that the information may have been discussed in open court, or may be available in court records, in public libraries, or in other public repositories does not, standing alone, mean that the information is generally known for Model Rule 1.9(c)(1) purposes.[19] Information that is publicly available is not necessarily generally known. Certainly, if information is publicly available but requires specialized knowledge or expertise to locate, it is not generally known within the meaning of Model Rule 1.9(c)(1).[20]

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had in mind situations in which a lawyer has worked with a company in various legal contexts, learned considerable information about its products and practices, and later seeks to use this information in connection with [the] representation of an adverse party in an unrelated lawsuit or transaction of some kind").

[19] *See In re* Gordon Props., LLC, 505 B.R. 703, 707 n.6 (Bankr. E.D. Va. 2013) ("'Generally known' does not mean information that someone can find. It means information that is already generally known. For example, a lawyer may have drafted a property settlement agreement in a divorce case and it may [be] in a case file in the courthouse where anyone could go, find it and read it. It is not 'generally known.' In some divorce cases, the property settlement agreement may become generally known, for example, in a case involving a celebrity, because the terms appear on the front page of the tabloids. 'Generally known' does not require publication on the front page of a tabloid, but it is more than merely sitting in a file in the courthouse."); *In re* Tennant, 392 P.3d 143, 148 (Mont. 2017) (holding that a lawyer who learned the information in question during his former clients' representation could not take advantage of his former clients "by retroactively relying on public records of their information for self-dealing"); ROTUNDA & DZIENKOWSKI, *supra* note 5, § 1.9-3, at 554 (explaining that Model Rule 1.9(c)(1) "deals with what has become generally known, not what is publicly available if you know exactly where to look"); *see also supra* note 6 (citing additional cases and materials).

[20] *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 59 cmt. d (2000) (stating, *inter alia*, that information is not generally known "when a person interested in knowing the information could obtain it only by means of special knowledge").

Conclusion

A lawyer may use information that is generally known to a former client's disadvantage without the former client's informed consent. Information is generally known within the meaning of Model Rule 1.9(c)(1) if it is widely recognized by members of the public in the relevant geographic area or it is widely recognized in the former client's industry, profession, or trade. For information to be generally known it must previously have been revealed by some source other than the lawyer or the lawyer's agents. Information that is publicly available is not necessarily generally known.

AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 480 **March 6, 2018**

Confidentiality Obligations for Lawyer Blogging and Other Public Commentary

Lawyers who blog or engage in other public commentary may not reveal information relating to a representation, including information contained in a public record, unless authorized by a provision of the Model Rules.[1]

Introduction

Lawyers comment on legal topics in various formats. The newest format is online publications such as blogs,[2] listserves, online articles, website postings, and brief online statements or microblogs (such as Twitter®) that "followers" (people who subscribe to a writer's online musings) read. Lawyers continue to present education programs and discuss legal topics in articles and chapters in traditional print media such as magazines, treatises, law firm white papers, and law reviews. They also make public remarks in online informational videos such as webinars and podcasts (collectively "public commentary").[3]

Lawyers who communicate about legal topics in public commentary must comply with the Model Rules of Professional Conduct, including the Rules regarding confidentiality of information relating to the representation of a client. A lawyer must maintain the confidentiality of information relating to the representation of a client, unless that client has given informed consent to the disclosure, the disclosure is impliedly authorized to carry out the representation, or the disclosure is permitted by Rule 1.6(b). A lawyer's public commentary may also implicate the lawyer's duties under other Rules, including Model Rules 3.5 (Impartiality and Decorum of the Tribunal) and 3.6 (Trial Publicity).

Online public commentary provides a way to share knowledge, opinions, experiences, and news. Many online forms of public commentary offer an interactive comment section, and, as such, are also a form of social media.[4] While technological advances have altered how lawyers

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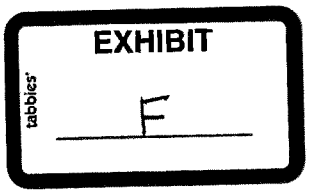
[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2016 [hereinafter the "Model Rules"]. The laws, court rules, regulations, rules of professional conduct and opinions promulgated in individual jurisdictions are controlling.

[2] A "blog" is commonly understood to be a website consisting of written entries (posts) regularly updated and typically written in an informal or conversational style by an individual or small group. As recently described in a California State Bar advisory opinion, "[b]logs written by lawyers run the gamut from those having nothing to do with the legal profession, to informational articles, to commentary on legal issues and the state of our system of justice, to self-promotional descriptions of the attorney's legal practice and courtroom successes to overt advertisements for the attorney or her law firm." State Bar of Cal. Comm'n on Prof'l Responsibility & Conduct Op. 2016-196 (2016).

[3] These are just examples of public written communications but this opinion is not limited to these formats. This opinion does not address the various obligations that may arise under Model Rules 7.1-7.5 governing advertising and solicitation, but lawyers may wish to consider their potential application to specific communications.

[4] Lawyers should take care to avoid inadvertently forming attorney-client relationships with readers of their public commentary. Although traditional print format commentary would not give rise to such concerns, lawyers interacting with readers through social media should be aware at least of its possibility. A lawyer commenting publicly about a legal matter standing alone would not create a client-lawyer relationship with readers of the commentary. *See* Model Rule 1.18 for duties to prospective clients. However, the ability of readers/viewers to make comments or to



communicate, and therefore may raise unexpected practical questions, they do not alter lawyers' fundamental ethical obligations when engaging in public commentary.[5]

Duty of Confidentiality Under Rule 1.6

Model Rule 1.6(a) provides:

> A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

As Comment [2] emphasizes, "[a] fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation."

This confidentiality rule "applies not only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source."[6] In other words, the scope of protection afforded by Rule 1.6 is far broader than attorney-client privileged information.

Unless one of the exceptions to Rule 1.6(a) is applicable, a lawyer is prohibited from commenting publicly about any information related to a representation. Even client identity is protected under Model Rule 1.6.[7] Rule 1.6(b) provides other exceptions to Rule 1.6(a).[8] However, because it is highly unlikely that a disclosure exception under Rule 1.6(b) would apply to a

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ask questions suggests that, where practicable, a lawyer include appropriate disclaimers on websites, blogs and the like, such as "reading/viewing this information does not create an attorney-client relationship."

Lawyer blogging may also create a positional conflict. *See* D.C. Bar Op. 370 (2016) (discussing lawyers' use of social media advising that "[c]aution should be exercised when stating positions on issues, as those stated positions could be adverse to an interest of a client, thus inadvertently creating a conflict.") *See also* ELLEN J. BENNETT, ELIZABETH J. COHEN & HELEN W. GUNNARSSON, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 148 (8th ed. 2015) (addressing positional conflicts). *See also* STEPHEN GILLERS, REGULATION OF LAWYERS: PROBLEMS OF LAW AND ETHICS 50-51 (11th ed. 2018) ("[S]ocial media presence can pose a risk for attorneys, who must be careful not to contradict their firm's official position on an issue in a pending case"). This opinion does not address positional conflicts.

[5] *Accord* D.C. Bar Op. 370 (2016) (stating that a lawyer who chooses to use social media must comply with ethics rules to the same extent as one communicating through more traditional forms of communication).

[6] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [3] (2017). There is also a general principle noted in the Restatement (Third) of the Law Governing Lawyers that "[c]onfidential client information does not include what a lawyer learns about the law, legal institutions such as courts and administrative agencies, and similar public matters in the course of representing clients." AMERICAN LAW INSTITUTE, RESTATEMENT OF THE LAW (THIRD) THE LAW GOVERNING LAWYERS §59, cmt. e (1998). It is beyond the scope of this opinion to define what specific elements will be considered to distinguish between protected client information and information about the law when they entwine.

[7] *See* Wis. Op. EF-17-02 (2017) ("a client's identity, as well as a former client's identity, is information protected by [Rule 1.6]"); State Bar of Nev. Comm'n on Ethics and Prof'l Responsibility Formal Op. 41, at 2 (2009) ("Even the mere identity of a client is protected by Rule 1.6."); State Bar of Ariz. Comm. on the Rules of Prof'l Conduct Op. 92-04 (1992) (explaining that a firm may not disclose list of client names with receivable amounts to a bank to obtain financing without client consent). *See also* MODEL RULES OF PROF'L CONDUCT R. 7.2 cmt. [2] (2017) & N.Y. Rules of Prof'l Conduct R. 7.1(b)(2) (requiring prior written consent to use a client name in advertising). *But see* Cal. Formal Op. 2011-182 (2011) ("...[I]n most situations, the identity of a client is not considered confidential and in such circumstances Attorney may disclose the fact of the representation to Prospective Client without Witness Client's consent.") (*citing to* LA County Bar Ass'n Prof'l Responsibility & Ethics Comm'n Op. 456 (1989)).

[8] *See* MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(1)-(7) (2017).

lawyer's public commentary, we assume for this opinion that exceptions arising under Rule 1.6(b) are not applicable.[9]

Significantly, information about a client's representation contained in a court's order, for example, although contained in a public document or record, is *not* exempt from the lawyer's duty of confidentiality under Model Rule 1.6.[10] The duty of confidentiality extends generally to information related to a representation whatever its source and without regard to the fact that others may be aware of or have access to such knowledge.[11]

A violation of Rule 1.6(a) is not avoided by describing public commentary as a "hypothetical" if there is a reasonable likelihood that a third party may ascertain the identity or situation of the client from the facts set forth in the hypothetical.[12] Hence, if a lawyer uses a hypothetical when offering public commentary, the hypothetical should be constructed so that there is no such likelihood.

The salient point is that when a lawyer participates in public commentary that includes client information, if the lawyer has not secured the client's informed consent or the disclosure is

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[9] For ethical issues raised when a lawyer is participating in an investigation or litigation and the lawyer makes extrajudicial statements, see *infra* at page 6.

[10] *See* ABA Formal Op. 479 (2017). *See also In re* Anonymous, 932 N.E.2d 671 (Ind. 2010) (neither client's prior disclosure of information relating to her divorce representation to friends nor availability of information in police reports and other public records absolved lawyer of violation of Rule 1.6); Iowa S. Ct. Attorney Disciplinary Bd. v. Marzen, 779 N.W.2d 757 (Iowa 2010) (all lawyer-client communications, even those including publicly available information, are confidential); Lawyer Disciplinary Bd. v. McGraw, 461 S.E.2d 850 (W. Va. 1995) ("[t]he ethical duty of confidentiality is not nullified by the fact that the information is part of a public record or by the fact that someone else is privy to it"); State Bar of Ariz. Op. 2000-11 (2000) (lawyer must "maintain the confidentiality of information relating to representation even if the information is a matter of public record"); State Bar of Nev. Op. 41 (2009) (contrasting broad language of Rule 1.6 with narrower language of Restatement (Third) of the Law Governing Lawyers); Pa. Bar Ass'n Informal Op. 2009-10 (2009) (absent client consent, lawyer may not report opponent's misconduct to disciplinary board even though it is recited in court's opinion); Colo. Formal Op. 130 (2017) ("Nor is there an exception for information otherwise publicly available. For example, without informed consent, a lawyer may not disclose information relating to the representation of a client even if the information has been in the news."); *But see In re* Sellers, 669 So. 2d 1204 (La. 1996) (lawyer violated Rule 4.1 by failing to disclose existence of collateral mortgage to third party; because "mortgage was filed in the public record, disclosure of its existence could not be a confidential communication, and was not prohibited by Rule 1.6"); Hunter v. Va. State Bar, 744 S.E.2d 611 (Va. 2013) (rejecting state bar's interpretation of Rule 1.6 as prohibiting lawyer from posting on his blog information previously revealed in completed public criminal trials of former clients). See discussion of *Hunter*, *infra*, at note 20.

[11] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 04-433 (2004) ("Indeed, the protection afforded by Rule 1.6 is not forfeited even when the information is available from other sources or publicly filed, such as in a malpractice action against the offending lawyer.")

[12] MODEL RULES OF PROF'L RESPONSIBILITY R. 1.6 cmt. [4] (2017). The possibility of violating Rule 1.6 using hypothetical facts was discussed in ABA Formal Opinion 98-411, which addressed a lawyer's ability to consult with another lawyer about a client's matter. That opinion was issued prior to the adoption of what is now Rule 1.6(b)(4) which permits lawyers to reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary to secure legal advice about the lawyer's compliance with these Rules. However, the directive provided in Formal Opinion 98-411 remains sound, namely, that a lawyer use caution when constructing a hypothetical. For an illustrative case, see *In re* Peshek, M.R. 23794, 2009 PR 00089 (Ill. 2010). Peshek was suspended for sixty days for violating Rule 1.6. Peshek served as a Winnebago County Public defender for about 19 years. After being assaulted by a client, Peshek began publishing an Internet blog, about a third of which was devoted to discussing her work at the public defender's office and her clients. Peshek's blog contained numerous entries about conversations with clients and various details of their cases, and Peshek referred to her clients by either first name, a derivative of their first name, or their jail ID number, which were held to be disclosures of confidential information in violation of Rule 1.6. She was suspended from practice for 60 days.

not otherwise impliedly authorized to carry out the representation, then the lawyer violates Rule 1.6(a).[13] Rule 1.6 does not provide an exception for information that is "generally known" or contained in a "public record."[14] Accordingly, if a lawyer wants to publicly reveal client information, the lawyer[15] must comply with Rule 1.6(a).[16]

First Amendment Considerations

While it is beyond the scope of the Committee's jurisdiction to opine on legal issues in formal opinions, often the application of the ethics rules interacts with a legal issue. Here lawyer speech relates to First Amendment speech. Although the First Amendment to the United States Constitution guarantees individuals' right to free speech, this right is not without bounds.[17] Lawyers' professional conduct may be constitutionally constrained by various professional regulatory standards as embodied in the Model Rules, or similar state analogs. For example, when a lawyer acts in a representative capacity, courts often conclude that the lawyer's free speech rights are limited.[18]

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[13] We again note that Rule 1.6(b) provides other exceptions to Rule 1.6(a).

[14] Model Rule 1.9 addresses the duties lawyers owe to former clients. Rule 1.9(c)(1) permits a lawyer, who has formerly represented a client, to use information related to the representation that has become generally known to the disadvantage of a former client, and Rule 1.9(c)(2) prohibits a lawyer from revealing information relating to the representation except as the Rules permit or require with respect to a current client. This opinion does not address these issues under Model Rule 1.9. The generally known exception in Rule 1.9(c)(1) is addressed in ABA Formal Opinion 479.

[15] Lawyers also have ethical obligations pursuant to Rules 5.1 and 5.3 to assure that lawyers and staff they supervise comply with these confidentiality obligations.

[16] In addition to the requirements of Rules 1.6(a), a lawyer may consider other practical client relations and ethics issues before discussing client information in public commentary to avoid disseminating information that the client may not want disseminated. For instance, Model Rule 1.8(b) reads: "A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules." Rule 1.8(b) could be read to suggest that a lawyer may use client information if it *does not* disadvantage a client. The lawyer, nevertheless, has a common-law fiduciary duty not to profit from using client information even if the use complies with the lawyer's ethical obligations. *See* RESTATEMENT OF THE LAW (THIRD) THE LAW GOVERNING LAWYERS § 60(2) (1998) ("a lawyer who uses confidential information of a client for the lawyer's pecuniary gain other than in the practice of law must account to the client for any profits made"). *Accord* D.C. Bar Op. 370 (2016) ("It is advisable that the attorney share a draft of the proposed post or blog entry with the client, so there can be no miscommunication regarding the nature of the content that the attorney wishes to make public. It is also advisable, should the client agree that the content may be made public, that the attorney obtain that client's consent in a written form.")

[17] *See* Gregory A. Garbacz, *Gentile v. State Bar of Nevada: Implications for the Media*, 49 WASH. & LEE L. REV. 671 (1992); D. Christopher Albright, *Gentile v. State Bar: Core Speech and a Lawyer's Pretrial Statements to the Press*, 1992 BYU L. REV. 809 (1992); Kathleen M. Sullivan, *The Intersection of Free Speech and the Legal Profession: Constraints on Lawyers' First Amendment Rights*, 67 FORDHAM L. REV. 569 (1998). *See also* Brandon v. Maricopa City, 849 F.3d 837 (9th Cir. 2017) (when a lawyer speaks to the media in her official capacity as an attorney for county officials, such speech involves her conduct as a lawyer and therefore is not "constitutionally protected citizen speech").

[18] *See In re* Snyder, 472 U.S. 634 (1985) (a law license requires conduct "compatible with the role of courts in the administration of justice"); U.S. Dist. Ct. E. Dist. of Wash. v. Sandlin, 12 F.3d 861 (9th Cir. 1993) ("once a lawyer is admitted to the bar, although he does not surrender his freedom of expression, he must temper his criticisms in accordance with professional standards of conduct"); *In re* Shearin, 765 A.2d 930 (Del. 2000) (lawyers' constitutional free speech rights are qualified by their ethical duties); Ky. Bar Ass'n v. Blum, 404 S.W.3d 841 (Ky. 2013) ("It has routinely been upheld that regulating the speech of attorneys is appropriate in order to maintain the public confidence and credibility of the judiciary and as a condition of '[t]he license granted by the court.'" [citing *Snyder*]); State ex rel. Neb. State Bar Ass'n v. Michaelis, 316 N.W.2d 46 (Neb. 1982) ("A layman may, perhaps, pursue his theories of free speech or political activities until he runs afoul of the penalties of libel or slander, or into

The plain language of Model Rule 1.6 dictates that information relating to the representation, even information that is provided in a public judicial proceeding, remains protected by Model Rule 1.6(a).[19] A lawyer may not voluntarily disclose such information, unless the lawyer obtains the client's informed consent, the disclosure is impliedly authorized to carry out the representation, or another exception to the Model Rule applies.[20]

At least since the adoption of the ABA Canons of Ethics, the privilege of practicing law has required lawyers to hold inviolate information about a client or a client's representation beyond that which is protected by the attorney-client privilege. Indeed, lawyer ethics rules in many jurisdictions recognize that the duty of confidentiality is so fundamental that it arises before a lawyer–client relationship forms, even if it never forms,[21] and lasts well beyond the end of the professional relationship.[22] It is principally, if not singularly, the duty of confidentiality that enables and encourages a client to communicate fully and frankly with his or her lawyer.[23]

Ethical Constraints on Trial Publicity and Other Statements

Model Rule 3.5 prohibits a lawyer from seeking to influence a judge, juror, prospective juror, or other official by means prohibited by law. Although using public commentary with the client's informed consent may be appropriate in certain circumstances, lawyers should take care not to run afoul of other limitations imposed by the Model Rules. [24]

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some infraction of our statutory law. A member of the bar can, and will, be stopped at the point where he infringes our Canons of Ethics.").

[19] *See* ABA Formal Op. 479 (2017). See also cases and authorities cited *supra* at note 10.

[20] One jurisdiction has held that a lawyer is not prohibited from writing a blog that includes information relating to a representation that was disclosed in an open public judicial proceeding after the public proceeding had concluded. In Hunter v. Virginia State Bar, 744 S.E.2d 611 (Va. 2013) the Supreme Court of Virginia held that the application of Virginia Rule of Professional Conduct 1.6(a) to Hunter's blog posts was an unconstitutional infringement of Hunter's free speech rights. The Committee regards *Hunter* as limited to its facts. Virginia's Rule 1.6 is different than the ABA Model Rule. The Virginia Supreme Court rejected the Virginia State Bar's position on the interpretation and importance of Rule 1.6 because there was "no evidence advanced to support it." But see *People vs. Isaac* which acknowledges *Hunter* but finds a violation of Colorado Rule 1.6. We note, further, that the holding in *Hunter* has been criticized. *See* Jan L. Jacobowitz & Kelly Rains Jesson, *Fidelity Diluted: Client Confidentiality Give Way to the First Amendment & Social Media in Virginia State Bar ex rel. Third District Committee v. Horace Frazier Hunter*, 36 CAMPBELL L. REV. 75, 98-106 (2013).

[21] *See* MODEL RULES OF PROF'L CONDUCT R. 1.18(b) (2017) (Even when no client–lawyer relationship ensues, a lawyer who has had discussions with a prospective client shall not use or reveal information learned in the consultation except as permitted by the Rules). *Implementation Chart on Model Rule 1.18*, American Bar Ass'n (Sept. 29, 2017), https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/mrpc_1_18.authcheckdam.pdf.

[22] *See* MODEL RULES OF PROF'L CONDUCT R. 1.9 (2017); *see also* D.C. Bar Op. 324 (Disclosure of Deceased Client's Files) (2004); Swidler & Berlin v. United States, 524 U.S. 399 (1998). *See also* GILLERS, *supra* note 4, at 34 ("[w]hether the [attorney-client] privilege survives death depends on the jurisdiction but in most places it does").

[23] See generally Preamble to ABA Model Rules for a general discussion of the purposes underlying the duty of confidentiality. *See also* GEOFFREY C. HAZARD JR. & W. WILLIAM HODES, THE LAW OF LAWYERING, §§ 9.2 & 9.3 at 9-6, 9-14 (3d ed. Supp. 2012).

[24] *See, e.g., In re* Joyce Nanine McCool 2015-B-0284 (Sup. Ct. La. 2015) (lawyer disciplined for violation of Rule 3.5 by attempting to communicate with potential jurors through public commentary); *see also* The Florida Bar v. Sean William Conway, No. SC08-326 (2008) (Sup. Ct. Fla.) (lawyer found to have violated Rules 8.4(a) and (d) for posting on the internet statements about a judge's qualifications that lawyer knew were false or with reckless disregard as to their truth or falsity).

Lawyers engaged in an investigation or litigation of a matter are subject to Model Rule 3.6, Trial Publicity. Paragraph (a) of Rule 3.6 (subject to the exceptions provided in paragraphs (b) or (c)) provides that:

> A lawyer who is participating or has participated in the investigation or litigation of a matter shall not make an extrajudicial statement that the lawyer knows or reasonably should know will be disseminated by means of public communication and will have a substantial likelihood of materially prejudicing an adjudicative proceeding in the matter.

Thus any public commentary about an investigation or ongoing litigation of a matter made by a lawyer would also violate Rule 3.6(a) if it has a substantial likelihood of materially prejudicing an adjudicative proceeding in the matter, and does not otherwise fall within the exceptions in paragraphs (b) or (c) of Model Rule 3.6.[25]

Conclusion

Lawyers who blog or engage in other public commentary may not reveal information relating to a representation that is protected by Rule 1.6(a), including information contained in a public record, unless disclosure is authorized under the Model Rules.

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[25] Pa. Bar Ass'n Formal Op. 2014-300 (2014) (lawyer involved in pending matter may not post about matter on social media). This opinion does not address whether a particular statement "will have a substantial likelihood of materially prejudicing an adjudicative proceeding" within the meaning of Model Rule 3.6.

AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 481 **April 17, 2018**

A Lawyer's Duty to Inform a Current or Former Client of the Lawyer's Material Error

Model Rule of Professional Conduct 1.4 requires a lawyer to inform a current client if the lawyer believes that he or she may have materially erred in the client's representation. Recognizing that errors occur along a continuum, an error is material if a disinterested lawyer would conclude that it is (a) reasonably likely to harm or prejudice a client; or (b) of such a nature that it would reasonably cause a client to consider terminating the representation even in the absence of harm or prejudice. No similar obligation exists under the Model Rules to a former client where the lawyer discovers after the attorney-client relationship has ended that the lawyer made a material error in the former client's representation.

Introduction

Even the best lawyers may err in the course of clients' representations. If a lawyer errs and the error is material, the lawyer must inform a current client of the error.[1] Recognizing that errors

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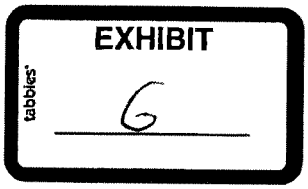
[1] A lawyer's duty to inform a current client of a material error has been variously explained or grounded. For malpractice and breach of fiduciary decisions, *see, e.g.*, Leonard v. Dorsey & Whitney LLP, 553 F.3d 609, 629 (8th Cir. 2009) (predicting Minnesota law and concluding that "the lawyer must know that there is a non-frivolous malpractice claim against him such that there is a substantial risk that [his] representation of the client would be materially and adversely affected by his own interest in avoiding malpractice liability" (internal quotation marks omitted)); Beal Bank, SSB v. Arter & Hadden, LLP, 167 P.3d 666, 673 (Cal. 2007) (stating that "attorneys have a fiduciary obligation to disclose material facts to their clients, an obligation that includes disclosure of acts of malpractice"); RFF Family P'ship, LP v. Burns & Levinson, LP, 991 N.E.2d 1066, 1076 (Mass. 2013) (discussing the fiduciary exception to the attorney-client privilege and stating that "a client is entitled to full and fair disclosure of facts that are relevant to the representation, including any bad news"); *In re* Tallon, 447 N.Y.S.2d 50, 51 (App. Div. 1982) ("An attorney has a professional duty to promptly notify his client of his failure to act and of the possible claim his client may thus have against him.").

For disciplinary decisions, *see, e.g.*, Fla. Bar v. Morse, 587 So. 2d 1120, 1120–21 (Fla. 1991) (suspending a lawyer who conspired with his partner to conceal the partner's malpractice from the client); *In re* Hoffman, 700 N.E.2d 1138, 1139 (Ind. 1998) (applying Rule 1.4(b)). *See also* Ill. State Bar Ass'n Mut. Ins. Co. v. Frank M. Greenfield & Assocs., P.C., 980 N.E.2d 1120, 1129 (Ill. App. Ct. 2012) (finding that a voluntary payments provision in a professional liability insurance policy was "against public policy, since it may operate to limit an attorney's disclosure [of his potential malpractice] to his clients").

For ethics opinions, *see, e.g.*, Cal. State Bar Comm. on Prof'l Responsibility & Conduct Op. 2009-178, 2009 WL 3270875, at *4 (2009) [hereinafter Cal. Eth. Op. 2009-178] ("A lawyer has an ethical obligation to keep a client informed of significant developments relating to the representation. . . . Where the lawyer believes that he or she has committed legal malpractice, the lawyer must promptly communicate the factual information pertaining to the client's potential malpractice claim against the lawyer to the client, because it is a 'significant development.'" (citation omitted)); Colo. Bar Ass'n, Ethics Comm., Formal Op. 113, at 3 (2005) [hereinafter Colo. Op. 113] ("Whether a particular error gives rise to an ethical duty to disclose [under Rule 1.4] depends on whether a disinterested lawyer would conclude that the error will likely result in prejudice to the client's right or claim and that the lawyer, therefore, has an ethical responsibility to disclose the error."); Minn. Lawyers Prof'l Responsibility Bd. Op. 21, 2009 WL 8396588, at *1 (2009) (imposing a duty to disclose under Rule 1.4 where "the lawyer knows the lawyer's conduct may reasonably be the basis for a non-frivolous malpractice claim by a current client that materially affects the client's



occur along a continuum, an error is material if a disinterested lawyer would conclude that it is (a) reasonably likely to harm or prejudice a client; or (b) of such a nature that it would reasonably cause a client to consider terminating the representation even in the absence of harm or prejudice.

If a material error relates to a former client's representation and the lawyer does not discover the error until after the representation has been terminated, the lawyer has no obligation under the Model Rules to inform the former client of the error. To illustrate, assume that a lawyer prepared a contract for a client in 2015. The matter is concluded, the representation has ended, and the person for whom the contract was prepared is not a client of the lawyer or law firm in any other matter. In 2018, while using that agreement as a template to prepare an agreement for a different client, the lawyer discovers a material error in the agreement. On those facts, the Model Rules do not require the lawyer to inform the former client of the error. Good business and risk management reasons may exist for lawyers to inform former clients of their material errors when they can do so in time to avoid or mitigate any potential harm or prejudice to the former client. Indeed, many lawyers would likely choose to do so for those or other individual reasons. Those are, however, personal decisions for lawyers rather than obligations imposed under the Model Rules.

The Duty to Inform a Current Client of a Material Error

A lawyer's responsibility to communicate with a client is governed by Model Rule 1.4.[2] Several parts of Model Rule 1.4(a) potentially apply where a lawyer may have erred in the course of a current client's representation. For example, Model Rule 1.4(a)(1) requires a lawyer to promptly inform a client of any decision or circumstance with respect to which the client's informed consent may be required. Model Rule 1.4(a)(2) requires a lawyer to "reasonably consult with the client about the means by which the client's objectives are to be accomplished." Model Rule 1.4(a)(3) obligates a lawyer to "keep a client reasonably informed about the status of a matter." Model Rule 1.4(a)(4), which obliges a lawyer to promptly comply with reasonable requests for information, may be implicated if the client asks about the lawyer's conduct or performance of the representation. In addition, Model Rule 1.4(b) requires a lawyer to "explain a

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interests"); 2015 N.C. State Bar Formal Op. 4, 2015 WL 5927498, at *2 (2015) [hereinafter 2015 N.C. Eth. Op. 4] (applying Rule 1.4 to "material errors that prejudice the client's rights or interests as well as errors that clearly give rise to a malpractice claim"; N.J. Sup. Ct. Advisory Comm. on Prof'l Ethics Op. 684, 1998 WL 35985928, at *1 (1998) [hereinafter N.J. Eth. Op. 684] (discussing Rules 1.4 and 1.7(b) and requiring disclosure "when the attorney ascertains malpractice may have occurred, even though no damage may yet have resulted"); N.Y. State Bar Ass'n Comm. on Prof'l Ethics Eth. Op. 734, 2000 WL 33347720, at *3 (2000) [hereinafter N.Y. Eth. Op. 734] (discussing the prior Code of Professional Responsibility and concluding that the inquirer had a duty to tell the client that it made "a significant error or omission that may give rise to a possible malpractice claim"); Sup. Ct. of Prof'l Ethics Comm. Op. 593, 2010 WL 1026287, at *1 (2010) [Tex. Eth. Op. 593] (opining that the lawyer must also terminate the representation and applying Texas Rules 1.15(d), 2.01, and 8.04(a)(3)). *See also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 20 cmt. c (2000) (requiring disclosure where the conduct "gives the client a substantial malpractice claim against the lawyer").

[2] MODEL RULES OF PROF'L CONDUCT R. 1.4 (2018) ("Communication") [hereinafter MODEL RULES].

matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." More broadly, the "guiding principle" undergirding Model Rule 1.4 is that "the lawyer should fulfill reasonable client expectations for information consistent with the duty to act in the client's best interests, and the client's overall requirements as to the character of representation."[3] A lawyer may not withhold information from a client to serve the lawyer's own interests or convenience.[4]

Determining whether and when a lawyer must inform a client of an error can sometimes be difficult because errors exist along a continuum. An error may be sufficiently serious that it creates a conflict of interest between the lawyer and the client. Model Rule 1.7(a)(2) provides that a concurrent conflict of interest exists if "there is a significant risk that the representation of one or more clients will be materially limited by . . . a personal interest of the lawyer." Where a lawyer's error creates a Rule 1.7(a)(2) conflict, the client needs to know this fact to make informed decisions regarding the representation, including whether to discharge the lawyer or to consent to the conflict of interest. At the other extreme, an error may be minor or easily correctable with no risk of harm or prejudice to the client.

Several state bars have addressed lawyers' duty to disclose errors to clients.[5] For example, in discussing the spectrum of errors that may arise in clients' representations, the North Carolina State Bar observed that "material errors that prejudice the client's rights or claims are at one end. These include errors that effectively undermine the achievement of the client's primary objective for the representation, such as failing to file the complaint before the statute of limitations runs."[6] At the other end of the spectrum are "nonsubstantive typographical errors" or "missing a deadline that causes nothing more than delay."[7] "Between the two ends of the spectrum are a range of errors that may or may not materially prejudice the client's interests."[8] With respect to the middle ground:

> Errors that fall between the two extremes of the spectrum must be analyzed under the duty to keep the client reasonably informed about his legal matter. If the error will result in financial loss to the client, substantial delay in achieving the client's objectives for the representation, or material disadvantage to the client's legal position, the error must be disclosed to the client. Similarly, if disclosure of the error is necessary for the client to make an informed decision about the representation or for the lawyer to advise the client of significant changes in strategy, timing, or direction of the representation, the lawyer may not withhold information about the error.[9]

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[3] *Id.* cmt. 5.
[4] *Id.* cmt. 7.
[5] *See supra* note 1 (listing authorities).
[6] 2015 N.C. Eth. Op. 4, *supra* note 1, 2015 WL 5927498, at *2.
[7] *Id.*
[8] *Id.*
[9] *Id.*

Another example is contained in the Colorado Bar Association's Ethics Committee in Formal Opinion 113, which discusses the spectrum of errors that may implicate a lawyers' duty of disclosure. In doing so, it identified errors ranging from those plainly requiring disclosure (a missed statute of limitations or a failure to file a timely appeal) to those "that may never cause harm to the client, either because any resulting harm is not reasonably foreseeable, there is no prejudice to a client's right or claim, or the lawyer takes corrective measures that are reasonably likely to avoid any such prejudice."[10] Errors by lawyers between these two extremes must be analyzed individually. For example, disclosure is not required where the law on an issue is unsettled and a lawyer makes a tactical decision among "equally viable alternatives."[11] On the other hand, "potential errors that may give rise to an ethical duty to disclose include the failure to request a jury in a pleading (or pay the jury fee), the failure to include an acceleration provision in a promissory note, and the failure to give timely notice under a contract or statute."[12] Ultimately, the Colorado Bar concluded that whether a particular error gives rise to an ethical obligation to disclose depends on whether the error is "material," which further "depends on whether a disinterested lawyer would conclude that the error will likely result in prejudice to the client's right or claim."[13]

These opinions provide helpful guidance to lawyers, but they do not—just as we do not—purport to precisely define the scope of a lawyer's disclosure obligations. Still, the Committee believes that lawyers deserve more specific guidance in evaluating their duty to disclose errors to current clients than has previously been available.

In attempting to define the boundaries of this obligation under Model Rule 1.4, it is unreasonable to conclude that a lawyer must inform a current client of an error only if that error may support a colorable legal malpractice claim, because a lawyer's error may impair a client's representation even if the client will never be able to prove all of the elements of malpractice. At the same time, a lawyer should not necessarily be able to avoid disclosure of an error absent apparent harm to the client because the lawyer's error may be of such a nature that it would cause a reasonable client to lose confidence in the lawyer's ability to perform the representation competently, diligently, or loyally despite the absence of clear harm. Finally, client protection and the purposes of legal representation dictate that the standard for imposing an obligation to disclose must be objective.

With these considerations in mind, the Committee concludes that a lawyer must inform a current client of a material error committed by the lawyer in the representation. An error is material if a disinterested lawyer would conclude that it is (a) reasonably likely to harm or prejudice a client; or (b) of such a nature that it would reasonably cause a client to consider terminating the representation even in the absence of harm or prejudice.

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[10] Colo. Op. 113, *supra* note 1, at 3.
[11] *Id.*
[12] *Id.*
[13] *Id.* at 1, 3.

A lawyer must notify a current client of a material error promptly under the circumstances.[14] Whether notification is prompt will be a case- and fact-specific inquiry. Greater urgency is required where the client could be harmed by any delay in notification. The lawyer may consult with his or her law firm's general counsel, another lawyer, or the lawyer's professional liability insurer before informing the client of the material error.[15] Such consultation should also be prompt. When it is reasonable to do so, the lawyer may attempt to correct the error before informing the client. Whether it is reasonable for the lawyer to attempt to correct the error before informing the client will depend on the facts and should take into account the time needed to correct the error and the lawyer's obligation to keep the client reasonably informed about the status of the matter.

When a Current Client Becomes a Former Client

As indicated earlier, whether a lawyer must reveal a material error depends on whether the affected person or entity is a current or former client. Substantive law, rather than rules of professional conduct, controls whether an attorney-client relationship exists, or once established, whether it is ongoing or has been concluded.[16] Generally speaking, a current client becomes a former client (a) at the time specified by the lawyer for the conclusion of the representation, and acknowledged by the client, such as where the lawyer's engagement letter states that the representation will conclude upon the lawyer sending a final invoice, or the lawyer sends a disengagement letter upon the completion of the matter (and thereafter acts consistently with the letter);[17] (b) when the lawyer withdraws from the representation pursuant to Model Rule of Professional Conduct 1.16; (c) when the client terminates the representation;[18] or (d) when overt acts inconsistent with the continuation of the attorney-client relationship indicate that the

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[14] *See* N.J. Eth. Op. 684, *supra* note 1, 1998 WL 35985928, at *1 ("Clearly, RPC 1.4 requires prompt disclosure in the interest of allowing the client to make informed decisions. Disclosure should therefore occur when the attorney ascertains malpractice may have occurred, even though no damage may yet have resulted."); 2015 N.C. Eth. Op. 4, *supra* note 1, 2015 WL 5927498, at *4 ("The error should be disclosed to the client as soon as possible after the lawyer determines that disclosure of the error to the client is required."); Tex. Eth. Op. 593, *supra* note 1, 2010 WL 1026287, at *1 (requiring disclosure "as promptly as reasonably possible").

[15] *See* MODEL RULES R. 1.6(b)(4) (2018) (permitting a lawyer to reveal information related to a client's representation "to secure legal advice about the lawyer's compliance with these Rules").

[16] United States v. Williams, 720 F.3d 674, 686 (8th Cir. 2013); Rozmus v. West, 13 Vet. App. 386, 387 (U.S. App. Vet. Cl. 2000); *see also* MODEL RULES Scope cmt. 17 (2018) (explaining that "for purposes of determining the lawyer's authority and responsibility, principles of substantive law external to these Rules determine whether a client-lawyer relationship exists").

[17] *See* Artromick Int'l, Inc. v. Drustar Inc., 134 F.R.D. 226, 229 (S.D. Ohio 1991) (observing that "the simplest way for either the attorney or client to end the relationship is by expressly saying so"); *see also, e.g.*, Rusk v. Harstad, 393 P.3d 341, 344 (Utah Ct. App. 2017) (concluding that a would-be client could not have reasonably believed that the law firm represented him where the lawyer had clearly stated in multiple e-mails that the law firm would not represent him).

[18] A client may discharge a lawyer at any time for any reason, or for no reason. White Pearl Inversiones S.A. (Uruguay) v. Cemusa, Inc., 647 F.3d 684, 689 (7th Cir. 2011); Nabi v. Sells, 892 N.Y.S.2d 41, 43 (App. Div. 2009); MODEL RULES R. 1.16 cmt. 4; *see also* STEPHEN GILLERS, REGULATION OF LAWYERS: PROBLEMS OF LAW AND ETHICS 77 (11th ed. 2018) ("Clients, it is said, may fire their lawyers for any reason or no reason.") (citations omitted).

relationship has ended.[19] If a lawyer represents a client in more than one matter, the client is a current client if any of those matters is active or open; in other words, the termination of representation in one or more matters does not transform a client into a former client if the lawyer still represents the client in other matters.

Absent express statements or overt acts by either party, an attorney-client relationship also may be terminated when it would be objectively unreasonable to continue to bind the parties to each other.[20] In such cases, the parties' reasonable expectations often hinge on the scope of the lawyer's representation.[21] In that regard, the court in *National Medical Care, Inc. v. Home Medical of America, Inc.*,[22] suggested that the scope of a lawyer's representation loosely falls into one of three categories: (1) the lawyer is retained as general counsel to handle all of the client's legal matters; (2) the lawyer is retained for all matters in a specific practice area; or (3) the lawyer is retained to represent the client in a discrete matter.[23]

For all three categories identified by the *National Medical Care* court, unless the client or lawyer terminates the representation, the attorney-client relationship continues as long as the lawyer is responsible for a pending matter.[24] With respect to categories one and two above, an attorney-client relationship continues even when the lawyer has no pending matter for the client because the parties reasonably expect that the lawyer will handle all matters for the client in the future as they arise.[25] In the third category, where a lawyer agrees to undertake a specific matter, the attorney-client relationship ends once the matter is concluded.[26]

Although not identified by the *National Medical Care* court, another type of client is what might be called an episodic client, meaning a client who engages the lawyer whenever the client requires legal representation, but whose legal needs are not constant or continuous. In many such

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[19] *See, e.g.*, Artromick Int'l, Inc., 134 F.R.D. at 230–31 (determining that a man was a former client because he refused to pay the lawyer's bill and then retained other lawyers to replace the first lawyer); Waterbury Garment Corp. v. Strata Prods., 554 F. Supp. 63, 66 (S.D.N.Y. 1982) (concluding that a person was a former client because the law firm represented him only in discrete transactions that had concluded and the person had subsequently retained different counsel).

[20] Artromick Int'l, Inc., 134 F.R.D. at 229.

[21] *Id.* at 229–30.

[22] No. 00-1225, 2002 WL 31068413 (Mass. Super. Ct. Sept. 12, 2002).

[23] *Id.* at *4.

[24] *Id.*; *see also* MODEL RULES R. 1.3 cmt. 4 (2018) (stating that unless the relationship is terminated under Model Rule 1.16, the lawyer "should carry through to conclusion all matters undertaken for a client").

[25] *See* Berry v. McFarland, 278 P.3d 407, 411 (Idaho 2012) (explaining that "[i]f the attorney agrees to handle any matters the client may have, the relationship continues until the attorney or client terminates the relationship"); *see also* MODEL RULES R. 1.3 cmt. 4 (2018) (advising that "[i]f a lawyer has served a client over a substantial period in a variety of matters, the client sometimes may assume that the lawyer will continue to serve on a continuing basis unless the lawyer gives notice of withdrawal").

[26] Simpson v. James, 903 F.2d 372, 376 (5th Cir. 1990); Berry, 278 P.3d at 411; *see also* Revise Clothing, Inc. v. Joe's Jeans Subsidiary, Inc., 687 F. Supp. 2d 381, 389–90 (S.D.N.Y. 2010) (noting that an attorney-client relationship is ordinarily terminated by the accomplishment of the purpose for which it was formed); Thayer v. Fuller & Henry Ltd., 503 F. Supp. 2d 887, 892 (N.D. Ohio 2007) (observing that an attorney-client relationship may terminate when the underlying action has concluded or when the attorney has exhausted all remedies and declined to provide additional legal services); MODEL RULES R. 1.16 cmt. 1 ("Ordinarily, a representation in a matter is completed when the agreed-upon assistance has been concluded.").

instances, the client reasonably expects that the professional relationship will span any intervals and that the lawyer will be available when the client next needs representation.[27] If so, the client should be considered a current client. In other instances, it is possible that the attorney-client relationship ended when the most recent matter concluded.[28] Whether an episodic client is a current or former client will thus depend on the facts of the case.

The Former Client Analysis Under the Model Rules

As explained above, a lawyer must inform a current client of a material error under Model Rule 1.4. Rule 1.4 imposes no similar duty to former clients.

Four of the five subparts in Model Rule 1.4(a) expressly refer to "the client" and the one that does not—Model Rule 1.4(a), governing lawyers' duty to respond to reasonable requests for information—is aimed at responding to requests from a current client. Model Rule 1.4(b) refers to "the client" when describing a lawyer's obligations. Nowhere does Model Rule 1.4 impose on lawyers a duty to communicate with former clients. The comments to Model Rule 1.4 are likewise focused on current clients and are silent with respect to communications with former clients. There is nothing in the legislative history of Model Rule 1.4 to suggest that the drafters meant the duties expressed there to apply to former clients.[29] Had the drafters of the Model Rules intended Rule 1.4 to apply to former clients, they presumably would have referred to former clients in the language of the rule or in the comments to the rule. They did neither despite knowing how to distinguish duties owed to current clients from duties owed to former clients when appropriate, as reflected in the Model Rules regulating conflicts of interest.[30]

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[27] *See, e.g.*, Parallel Iron, LLC v. Adobe Sys. Inc., C.A. No. 12-874-RGA, 2013 WL 789207, at *2–3 (D. Del. Mar. 4, 2013) (concluding that Adobe was a current client in July 2012 when the law firm was doing no work for it; the firm had served as patent counsel to Adobe intermittently between 2006 and February 2012, and had not made clear to Adobe that its representation was terminated); Jones v. Rabanco, Ltd., No. C03-3195P, 2006 WL 2237708, at *3 (W.D. Wash. Aug. 3, 2006) (reasoning that the law firm's inclusion as a contact under a contract, the law firm's work for the client after the contract was finalized, and the fact that the client matter was still open in the law firm's files all indicated an existing attorney-client relationship); STEPHEN GILLERS, REGULATION OF LAWYERS: PROBLEMS OF LAW AND ETHICS 78-79 (11th ed. 2018) ("Lawyers might believe that a client is no longer a client if they are doing no work for it at the moment and haven't for a while. . . . [A] firm may have done work for a client two or three times a year for the past five years, creating a reasonable client expectation that the professional relationship continues during the intervals and that the lawyer will be available the next time the client needs her.").

[28] *See, e.g.*, Calamar Enters., Inc. v. Blue Forest Land Grp., Inc., 222 F. Supp. 3d 257, 264–65 (W.D.N.Y. 2016) (rejecting the client's claim of an attorney-client relationship where the relationship between the law firm and the client had been dormant for three years; despite the fact that the attorney-client relationship had not been formally terminated, it ended when the purpose of the parties' retainer agreement had been completed).

[29] AM. BAR ASS'N CTR. FOR PROF'L RESPONSIBILITY, A LEGISLATIVE HISTORY: THE DEVELOPMENT OF THE ABA MODEL RULES OF PROFESSIONAL CONDUCT, 1982–2013, 71–78 (Arthur H. Garwin ed., 2013).

[30] *Compare* MODEL RULES R. 1.7 (2018) (addressing current client conflicts of interest), *with* MODEL RULES R. 1.9 (2018) (governing former client conflicts of interest).

Because Model Rule 1.4 does not impose on lawyers a duty to communicate with former clients,[31] it is no basis for requiring lawyers to disclose material errors to former clients.

The California State Bar's Committee on Professional Responsibility and Conduct reached a similar conclusion with respect to California Rule of Professional Conduct 3-500, which states that "[a] member [of the State Bar of California] shall keep a client reasonably informed about significant developments relating to the employment or representation, including promptly complying with reasonable requests for information and copies of significant documents when necessary to keep the client so informed." In concluding that a lawyer had no duty to keep a former client informed of significant developments in the representation, and specifically the former client's possible malpractice claim against the lawyer, the Committee focused on the fact that the lawyer and the former client had "terminated their attorney-client relationship" and on Rule 3-500's reference to a "client," meaning a current client.[32]

Finally, in terms of possible sources of an obligation to disclose material errors to former clients, Model Rule 1.16(d) provides in pertinent part that, upon termination of a representation, "a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee[s] or expense[s] that has not been earned or incurred." This provision does not create a duty to inform former clients of material errors for at least two reasons. First, the wording of the rule demonstrates that the error would have to be discovered while the client was a current client, thereby pushing any duty to disclose back into the current client communication regime. Second, Model Rule 1.16(d) is by its terms limited to actions that may be taken upon termination of the representation or soon thereafter; it cannot reasonably be construed to apply to material errors discovered months or years after termination of the representation.

Conclusion

The Model Rules require a lawyer to inform a current client if the lawyer believes that he or she may have materially erred in the client's representation. Recognizing that errors occur along a continuum, an error is material if a disinterested lawyer would conclude that it is (a) reasonably likely to harm or prejudice a client; or (b) of such a nature that it would reasonably cause a client to consider terminating the representation even in the absence of harm or prejudice. The lawyer

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[31] *See* Sup. Ct. of Ohio, Bd. of Comm'rs on Grievances & Discipline Adv. Op. 2010-2, 2010 WL 1541844, at *2 (2010) (explaining that Rule 1.4 "applies to ethical duties regarding communication *during a representation*" (emphasis added)); Va. State Bar Comm. on Legal Ethics Eth. Op. 1789, 2004 WL 436386, at *1 (2004) (stating that "*[d]uring the course of the representation*, an attorney's duty to provide information to his client is governed by Rule 1.4(a)") (emphasis added)).

[32] Cal. Eth. Op. 2009-178, *supra* note 1, 2009 WL 3270875, at *6.

must so inform the client promptly under the circumstances. Whether notification is prompt is a case- and fact-specific inquiry.

No similar duty of disclosure exists under the Model Rules where the lawyer discovers after the termination of the attorney-client relationship that the lawyer made a material error in the former client's representation.

AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 482 **September 19, 2018**

Ethical Obligations Related to Disasters

The Rules of Professional Conduct apply to lawyers affected by disasters. Model Rule 1.4 (communication) requires lawyers to take reasonable steps to communicate with clients after a disaster. Model Rule 1.1 (competence) requires lawyers to develop sufficient competence in technology to meet their obligations under the Rules after a disaster. Model Rule 1.15 (safekeeping property) requires lawyers to protect trust accounts, documents and property the lawyer is holding for clients or third parties. Model Rule 5.5 (multijurisdictional practice) limits practice by lawyers displaced by a disaster. Model Rules 7.1 through 7.3 limit lawyers' advertising directed to and solicitation of disaster victims. By proper advance preparation and planning and taking advantage of available technology during recovery efforts, lawyers can reduce their risk of violating the Rules of Professional Conduct after a disaster.

Introduction[1]

Recent large-scale disasters highlight the need for lawyers to understand their ethical responsibilities when those events occur. Extreme weather events such as hurricanes, floods, tornadoes, and fires have the potential to destroy property or cause the long-term loss of power. Lawyers have an ethical obligation to implement reasonable measures to safeguard property and funds they hold for clients or third parties, prepare for business interruption, and keep clients informed about how to contact the lawyers (or their successor counsel). Lawyers also must follow the advertising rules if soliciting victims affected by a disaster.

Much information is available to lawyers about disaster preparedness. The American Bar Association has a committee devoted solely to the topic and provides helpful resources on its website.[2] These resources include practical advice on (i) obtaining insurance, (ii) types and methods of information retention, and (iii) steps to take immediately after a disaster to assess damage and rebuild. Lawyers should review these and other resources and take reasonable steps

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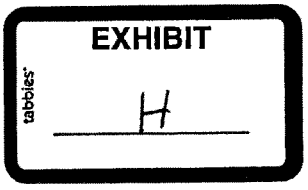
[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2018. The laws, court rules, regulations, rules of professional conduct and opinions promulgated in individual jurisdictions are controlling.

[2] ABA COMMITTEE ON DISASTER RESPONSE AND PREPAREDNESS, https://www.americanbar.org/groups/committees/disaster.html (last visited Sept. 6, 2018). ABA Committee on Disaster Response and Preparedness, *Surviving a Disaster A Lawyer's Guide* (Aug. 2011), https://www.americanbar.org/content/dam/aba/events/disaster/surviving_a_disaster_a_lawyers_guide_to_disaster_planning.authcheckdam.pdf.



to prepare for a disaster before one strikes the communities in which they practice. Lawyers should also review their disaster preparedness plans when a disaster threatens. Included within disaster planning, and of particular importance for sole practitioners, is succession planning so that clients and others know where to turn if a lawyer dies, is incapacitated, or is displaced by a disaster.

Despite the wealth of information available on preparing for a disaster and on the practical steps a lawyer should take to preserve the lawyers' and the clients' property and interests after a disaster, there is a dearth of guidance on a lawyer's ethical responsibilities (i) when a disaster threatens, and (ii) after a disaster occurs.[3] This opinion addresses the lawyers' obligations in these circumstances.[4]

A. Communication

Model Rule 1.4 requires lawyers to communicate with clients.[5] One of the early steps lawyers will have to take after a disaster is determining the available methods to communicate with clients. To be able to reach clients following a disaster, lawyers should maintain, or be able

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[3] There are three ethics opinions from state bars on a lawyer's obligations after a disaster: N.Y. City Bar Ass'n Formal Op. 2015-6 (2015) advises lawyers to notify clients of destruction of client files in a disaster if the destroyed documents have intrinsic value (such as a will) or if the lawyer knows the client may need the documents; La. Advisory Op. 05-RPCC-005 (2005) advises lawyers on providing pro bono assistance through a hotline or both; and State Bar of Cal. Standing Comm. on Prof'l Responsibility & Conduct, Formal Op. 2004-166 (2004) advises lawyers not to participate in a mass disaster victims chat room because it is intrusive, but not because it is prohibited as in-person solicitation.

[4] This opinion focuses primarily on the obligations of managers and supervisors within the meaning of Rule 5.1, recognizing that lawyers practice in a variety of contexts, including solo offices, small firms, large firms, government agencies and corporate offices. Subordinate lawyers may rely on the reasonable decisions of managers and supervisors on how to address the ethical obligations this opinion describes. Some of the obligations may be reasonably delegated or assigned to specific lawyers within a firm or organization. Methods of compliance with the obligations may vary depending on the practice context in which they arise. In addition, lawyers employed by governmental or other institutional entities may be subject to requirements imposed by law, or the policies of those entities. Reasonable implementation of the obligations described in this opinion satisfies the Model Rules. Opinion 467 provides examples of how to comply with obligations under several Model Rules in a variety of practice settings. *See* ABA Comm'n on Ethics & Prof'l Responsibility, Formal Op. 467 (2014).

[5] MODEL RULES OF PROF'L CONDUCT R. 1.4 (2018) provides:

(a) A lawyer shall:

(1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;

(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) keep the client reasonably informed about the status of the matter;

(4) promptly comply with reasonable requests for information; and

(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

to create on short notice, electronic or paper lists of current clients and their contact information. This information should be stored in a manner that is easily accessible.[6]

In these early communications clients will need to know, for example, if the lawyer remains available to handle the client's matters, or, alternatively, if the lawyer is unavailable because of the disaster's effects, and may need to withdraw. In a situation in which a disaster is predicted, for example, with a hurricane or other extreme weather event, lawyers should consider providing clients with methods by which the lawyer may be reached in the event that emergency communication is necessary. Information about how to contact the lawyer in the event of an emergency may be provided in a fee agreement or an engagement letter.[7]

In identifying how to communicate with clients under these circumstances, lawyers must be mindful of their obligation under Rule 1.1 to keep abreast of technology relevant to law practice[8] and Rule 1.6(c)'s requirement "to make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of the client."[9]

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[6] This opinion addresses a lawyer's ethical responsibilities. Lawyers should take similar steps to maintain communication with their own colleagues and staff. It is also good practice for a lawyer to maintain and update this information on a secure Internet website after the disaster so that colleagues and support staff will have a centralized location to find contact information. For information about the appropriate methods for storing electronic or paper records, lawyers may consult the ABA Committee on Disaster Response and Preparedness website. Also, many state bars and courts provide information on disaster preparedness.

[7] Practical problems a lawyer may wish to consider in advance include whether (i) landline phones will be out of service, (ii) the U.S. Postal Service will be impaired, and (iii) electronic devices will lose battery power.

[8] ABA Model Rule 1.1 provides, "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." Comment [8] to Rule 1.1 provides: ". . . [A] lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology . . . ."

[9] As this Committee has previously noted, lawyers may transmit confidential information over the Internet if the lawyer has made reasonable efforts to prevent accidental or unauthorized access to the information. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (May 22, 2017). *See also* Alaska Bar Ass'n Op. 98-2 (1998); State Bar of Ariz. Formal Op. 97-04 (1997); State Bar of Cal. Standing Comm. on Prof'l Responsibility & Conduct, Formal Op. 2010-179 (2010); D.C. Bar Op. 281 (1998); Del. State Bar Ass'n Comm. on Prof'l Ethics Op. 2001-2 (2001); Haw. State Ethics Comm'n Formal Op. 40 (2001); Ill. State Bar Ass'n Advisory Op. 96-10 (1997); Iowa State Bar Ass'n Op. 15-01 (2015); N.C. State Bar Op. RPC 215 (1995); State Bar Ass'n of N.D. Advisory Op. 97-09 (1997); Ohio Bd. of Cmss'rs on Grievances & Discipline Op. 99-2 (1999); S.C. Bar Advisory Op. 97-08 (1997); Prof'l Ethics Comm. State Bar of Tex. Op. 648 (2015); Utah State Bar Advisory Op. 00-01 (2000); Vt. Advisory Op. 97-5 (1997); Wash. State Bar Ass'n Advisory Op. 2175 (2008).

B. Continued Representation in the Affected Area

Lawyers who continue to provide legal services in the area affected by a disaster have the same ethical obligations to their clients as before the disaster, although they may be able to provide advice outside their normal area of expertise.[10]

Lawyers may not be able to gain access to paper files following a disaster.[11] Consequently, lawyers must evaluate in advance storing files electronically so that they will have access to those files via the Internet if they have access to a working computer or smart device after a disaster. If Internet access to files is provided through a cloud service, the lawyer should (i) choose a reputable company, and (ii) take reasonable steps to ensure that the confidentiality of client information is preserved, and that the information is readily accessible to the lawyer.[12]

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[10] Comment [3] to Rule 1.1 allows: "In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances. Ill-considered action under emergency conditions can jeopardize the client's interest."

[11] Rule 1.15 requires that lawyers take reasonable steps to preserve trust account records and documents and property of clients and third parties when a lawyer has notice of an impending disaster. *See also* subsection (E), *infra*, for a discussion of a lawyer's obligations when files are lost or destroyed in a disaster.

[12] Lawyers must understand that electronically stored information is subject to cyberattack, know where the information is stored, and adopt reasonable security measures. They must conduct due diligence in selecting an appropriate repository of client information "in the cloud." Among suggested areas of inquiry are determining legal standards for confidentiality and privilege in the jurisdiction where any dispute will arise regarding the cloud computing services. *See* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (May 22, 2017) (Lawyer may send client information over the Internet if lawyer makes reasonable efforts to prevent inadvertent or unauthorized access, but may be required to take special security precautions when required by an agreement with the client or by law, or when the nature of the information requires a higher degree of security); Ala. State Bar Op. 2010-02 (2010) (Lawyer may outsource storage of client files through cloud computing if they take reasonable steps to make sure data is protected); State Bar of Ariz. Formal Op. 09-04 (2009) (Lawyer may use online file storage and retrieval system that enables clients to access their files over the Internet, as long as the firm takes reasonable precautions to protect the confidentiality of the information; in this case, proposal would convert files to password-protected pdf documents that are stored on a Secure Socket Layer server (SSL) which encodes the documents); State Bar of Cal. Standing Comm. on Prof'l Responsibility & Conduct, Formal Op. 2012-184 (2012) (Lawyer may operate virtual law office "in the cloud" as long as the lawyer complies with all ethical duties such as confidentiality, competence, communication, and supervision; lawyer should check vendor credentials, data security, how information is transmitted, whether through other jurisdictions or third-party servers, the ability to supervise the vendor; and the terms of the contract with the vendor); Fla. Bar Op. 12-3 (2013) (Lawyers may use cloud computing if they take reasonable precautions to ensure that confidentiality of client information is maintained, that the service provider maintains adequate security, and that the lawyer has adequate access to the information stored remotely); Ill. State Bar Ass'n Op. 16-06 (2016) (Lawyer may use cloud-based service to store client files as long as the lawyer "takes reasonable measures to ensure that the client information remains confidential and is protected from breaches"; lawyer should engage in due diligence in choosing the provider, including reviewing industry norms, determining the provider's security precautions such as firewalls, password protection and encryption, the provider's reputation and history, asking about any prior breaches, requiring that the provider follow confidentiality requirements, requiring that the data is under the lawyer's control, and requiring reasonable access if the contract terminates or the provider goes out of business); Iowa State Bar Ass'n Op. 11-01 (2011) (Due diligence a lawyer

As part of the obligation of competence under Rule 1.1 and diligence under Rule 1.3, lawyers who represent clients in litigation must be aware of court deadlines, and any extensions granted due to the disaster. Courts typically issue orders, usually posted on their websites, addressing extensions.[13] Lawyers should check with the courts and bar associations in their jurisdictions to determine whether deadlines have been extended.

Lawyers also must take reasonable steps in the event of a disaster to ensure access to funds the lawyer is holding in trust. A lawyer's obligations with respect to these funds will vary depending on the circumstances. Even before a disaster, all lawyers should consider (i) providing for another trusted signatory on trust accounts in the event of the lawyer's unexpected death, incapacity, or prolonged unavailability and (ii) depending on the circumstances and jurisdiction, designating a successor lawyer to wind up the lawyer's practice.[14] Lawyers with notice of an

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should perform before storing files electronically with a third party using SaaS (cloud computing) includes whether the lawyer will have adequate access to the stored information, whether the lawyer will be able to restrict access of others to the stored information, whether data is encrypted and password protected, and what will happen to the information in the event the lawyer defaults on an agreement with the third party provider or terminates the relationship with the third party provider); State Bar of Nev. Formal Op. 33 (2006) (Lawyer may store client files electronically on a remote server controlled by a third party as long as the firm takes precautions to safeguard confidential information such as obtaining the third party's agreement to maintain confidentiality); New York City Bar Report, *The Cloud and the Small Law Firm: Business, Ethics and Privilege Considerations* (Nov. 2013), https://www2.nycbar.org/pdf/report/uploads/20072378-TheCloudandtheSmallLawFirm.pdf; N.Y. State Bar Ass'n Op. 842 (2010) (Permissible to use an online computer data storage system to store client files provided the attorney takes reasonable care to maintain confidentiality; lawyer must stay informed of both technological advances that could affect confidentiality and changes in the law that could affect privilege); State Bar Ass'n of N.D. Advisory Op. 99-03 (1999) (Permissible to use electronic online data service to store files as long as the lawyer properly protects confidential client information, perhaps via password protected storage); Pa. Bar Ass'n Op. 2011-200 (2011) ("An attorney may ethically allow client confidential material to be stored in 'the cloud' provided the attorney takes reasonable care to assure that (1) all such materials remain confidential, and (2) reasonable safeguards are employed to ensure that the data is protected from breaches, data loss and other risks"); S.C. Bar Advisory Op. 86-23 (1988) (A lawyer can store files in a storage facility operated by a third party if the lawyer ensures that confidentiality is maintained); Tenn. Formal Op. 2015-F-159 (2015) (Lawyer may store information in the cloud if the lawyer takes reasonable measures to protect the information); Vt. Advisory Op. 2010-6 (2010) (Lawyers may use cloud computing if they take reasonable steps to ensure confidentiality of information and that information is accessible).

[13] *See, e.g.*, Sup. Ct. of Fla. Administrative Order No. AOSC17-57 (2017), http://www.floridasupremecourt.org/clerk/adminorders/2017/AOSC17-57.pdf (extending time periods in the wake of Hurricane Irma); N.D. Sup. Ct. Administrative Order 20 (2011), http://www.ndcourts.gov/court/rules/administrative/ao20.htm (staying deadlines due to flooding); N.D. Sup. Ct. Rules Section 6, Emergency Procedural Rule, Administrative Rule, or Administrative Order, *available at* http://www.ndcourts.gov/court/rules/administrative/ao20.htm (last visited Sept. 4, 2018); Sup. Ct. of Texas Emergency Order Suspending Criminal Court Proceedings in the Wake of Hurricane Harvey (2017), http://www.txcourts.gov/media/1438759/179091.pdf; Supreme Court of Texas Emergency Order on Statutes of Limitations in Civil Cases in the Wake of Hurricane Harvey (2017), http://www.txcourts.gov/media/1438804/179098.pdf.

[14] *See* MODEL RULES OF PROF'L CONDUCT R. 1.1 & 1.3 (2018). Designating a successor and adding trusted signatories are good practices that may already be in place as part of normal succession planning. Some states require designation of a successor counsel or inventory lawyer. *See, e.g.*, Rules Regulating the Fla. Bar R. 1-3.8(e),

impending disaster should take additional steps. For example, a transactional lawyer should review open files to determine if the lawyer should transfer funds to a trust account that will be accessible after the disaster or even attempt to complete imminent transactions prior to the disaster if practicable.

A disaster may affect the financial institution in which funds are held, or the lawyer's ability to communicate with the financial institution. Consequently, lawyers should take appropriate steps in advance to determine how they will obtain access to their accounts after a disaster. Different institutions may have varying abilities to recover from a disaster.[15] After a disaster, a lawyer must notify clients or third persons for whom the lawyer is holding funds when required disbursements are imminent and the lawyer is unable to access the funds, even if the lawyer cannot access the funds because the financial institution itself is inaccessible or access is beyond the lawyer's capability.[16]

C. Withdrawal from Representation After a Disaster

Lawyers whose circumstances following a disaster render them unable to fulfill their ethical responsibilities to clients may be required to withdraw from those representations. Rule 1.16(a)(1) requires withdrawal if representation will cause the lawyer to violate the rules of professional conduct. Rule 1.16(a)(2) requires withdrawal if "the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client," for example, if the lawyer suffers severe injury or mental distress due to the disaster. Rule 1.16(b)(7) allows termination of the representation when the lawyer has "other good cause for withdrawal." These conditions may be present following a disaster. In determining whether withdrawal is required, lawyers must assess whether the client needs immediate legal services that the lawyer will be unable to timely

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Iowa Ct. Rule 39.18(1), Me. Bar R. 32(a), and Mo. R. 4-1.3 cmt. [5] & R. 5.26. Some states permit voluntary designation, including California, Delaware, Idaho, South Carolina, and Tennessee. *See Mandatory Successor Rule Chart* (June 2015), ABA, https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/mandatory_successor_rule_chart.authcheckdam.pdf. Lawyers should also be aware that, in most jurisdictions, a power of attorney to handle law firm affairs will be insufficient because it expires on the principal's death.

[15] The rules do not require a lawyer to place funds in a large or national financial institution. *See* MODEL RULES OF PROF'L CONDUCT R. 1.15 (2018). However, a prudent lawyer in a disaster-prone area should inquire about a financial institution's disaster preparedness before placing funds there. The lawyer must comply with IOLTA requirements regardless of which financial institution the lawyer chooses.

[16] MODEL RULES OF PROF'L CONDUCT R. 1.4 and 1.15(d) (2018).

provide. Lawyers who are unable to continue client representation in litigation matters must seek the court's permission to withdraw as required by law and court rules.[17]

D. Representation of Clients by Displaced Lawyers in Another Jurisdiction

Some lawyers may either permanently or temporarily re-locate to another jurisdiction following a disaster. Their clients and other residents of the lawyers' home jurisdiction may relocate to the same jurisdiction, or elsewhere, and still require legal services. Although displaced lawyers may be able to rely on Model Rule 5.5(c) allowing temporary multijurisdictional practice to provide legal services to their clients or displaced residents, they should not assume the Rule will apply in a particular jurisdiction. Comment [14] to Rule 5.5 provides:

> . . . lawyers from the affected jurisdiction [by a major disaster] who seek to practice law temporarily in another jurisdiction, but in which they are not otherwise authorized to practice law, should consult the Model Court Rule on Provision of Legal Services Following Determination of Major Disaster.

Displaced lawyers who wish to practice law in another jurisdiction may do so only as authorized by that other jurisdiction. Subdivision (c) of the ABA Model Court Rule on Provision of Legal Services Following Determination of Major Disaster provides:

> Following the determination of a major disaster in another United States jurisdiction, a lawyer who is authorized to practice law and who principally practices in that affected jurisdiction, and who is not disbarred, suspended from practice or otherwise restricted from practice in any jurisdiction, may provide legal services in this jurisdiction on a temporary basis if permitted by order of the highest court of the other jurisdiction. Those legal services must arise out of and be reasonably related to that lawyer's practice of law in the jurisdiction, or area of such other jurisdiction, where the major disaster occurred.[18]

This ABA Model Court Rule further provides that lawyers:

- are required to register with the Supreme Court in the state where they are temporarily allowed to practice;

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[17] MODEL RULES OF PROF'L CONDUCT R. 1.16(c) (2018).

[18] Full text of the ABA Model Court Rule on Provision of Legal Services Following Determination of Major Disaster (2007) can be found at: https://www.americanbar.org/content/dam/aba/migrated/2011_build/professional_responsibility/model_rule_disaster_katrina.authcheckdam.pdf. The ABA Standing Committee on Client Protection Chart on State Implementation of the ABA Model Court Rule on Provision of Legal Services Following Determination of Major Disaster (Sept. 8, 2017) can be found at: https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/katrina_chart.authcheckdam.pdf.

- are subject to the disciplinary authority in the jurisdiction of the Supreme Court in the state where they are temporarily allowed to practice; and
- must cease practice within 60 days after the Supreme Court in the state where they are temporarily allowed to practice determines the conditions of the disaster have ended.[19]

E. Loss of Files and Other Client Property

Some lawyers located in an area affected by a disaster may have their files destroyed. Lawyers who maintain only paper files or maintain electronic files solely on a local computer or local server are at higher risk of losing those records in a disaster. A lawyer's responsibilities regarding these files vary depending on the nature of the stored documents and the status of the affected clients.

Under the lawyer's duty to communicate, a lawyer must notify current clients of the loss of documents with intrinsic value, such as original executed wills and trusts, deeds, and negotiable instruments.[20] Lawyers also must notify former clients of the loss of documents and other client property with intrinsic value. A lawyer's obligation to former clients is based on the lawyer's obligation to safeguard client property under Rule 1.15.[21] Under the same Rule, lawyers must

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[19] *See* ABA Model Court Rule Provision of Legal Services Following Determination of Major Disaster, *supra* note 17. For an example, see the emergency order entered by the Supreme Court of Texas in 2017, permitting the temporary practice of Texas law by lawyers displaced from their home jurisdictions after Hurricane Harvey. The Court adopted requirements and limitations similar to those in the ABA Model Court Rule. *See* Court of Texas Amended Emergency Order After Hurricane Harvey Permitting Out-of-State Lawyers to Practice Texas Law Temporarily, Misc. Docket No. 17-9101 (Aug. 30, 2017), *available at* http://www.txcourts.gov/media/1438820/179101.pdf.

[20] *See* MODEL RULES OF PROF'L CONDUCT R. 1.4 (2018); N.Y. City Bar Ass'n Formal Op. 2015-6 (2015); *See also* ABA Comm. on Ethics & Prof'l Responsibility, Informal Op. 1384 (1977) (Lawyer should not dispose of client property without client consent, should not destroy information that would be useful to the client if the statute of limitations has not run, should not destroy information that the client may need and is not otherwise easily accessible by the client, should exercise discretion in determining which information might be particularly sensitive or require longer retention than others, should retain trust account records, should protect confidentiality in the destruction of any files, should review files before destruction to determine if portions should be retained, and should retain an index of destroyed files); State Bar of Cal. Standing Comm. on Prof'l Responsibility & Conduct, Formal Op. 2001-157 (2001) (Regarding destruction of closed files, indicating that property of the client such as original documents (like wills) is subject to bailment law or other statute, lawyers may not destroy other file materials without making reasonable efforts to obtain client consent, lawyers may not destroy items required to be retained by law, lawyers may not destroy items if destruction would prejudice the clients' interests, and criminal case files should not be destroyed while the client is living); State Bar of Mich. Op. R-12 (1991) (Lawyers must give notice to clients regarding file destruction after 1998, files before 1998 may not be destroyed without reasonable efforts to notify the client, and lawyers are not required to notify clients of file destruction if the lawyer maintains a copy of the documents on microfilm (excluding original documents of the client or if destruction of the documents would prejudice the client's interests)). Lawyers should note that in some states, the client may be entitled to all substantive documents in the file at the client's request. *See e.g.*, State Bar of Ariz. Op. 15-02 (2015).

[21] *See also* N.Y. City Bar Ass'n Formal Op. 2015-6 (2015).

make reasonable efforts to reconstruct documents of intrinsic value for both current and former clients, or to obtain copies of the documents that come from an external source.[22]

A lawyer need not notify either current or former clients about lost documents that have no intrinsic value, that serve no useful purpose to the client or former client, or for which there are electronic copies. The lawyer must respond honestly, however, if asked about those documents by either current or former clients.[23]

The largest category of documents will fall in the middle; i.e., they are necessary for current representation or would serve some useful purpose to the client. For current clients, lawyers may first attempt to reconstruct files by obtaining documents from other sources. If the lawyer cannot reconstruct the file, the lawyer must promptly notify current clients of the loss. This obligation stems from the lawyer's obligations to communicate with clients and represent them competently and diligently.[24] A lawyer is not required either to reconstruct the documents or to notify former clients of the loss of documents that have no intrinsic value, unless the lawyer has agreed to do so despite the termination of the lawyer-client relationship.[25]

ABA Model Rule 1.15(a) also requires lawyers to keep complete records accounting for funds and property of clients and third parties held by the lawyer and to preserve those records for five years after the end of representation. A lawyer whose trust account records are lost or destroyed in a disaster must attempt to reconstruct those records from other available sources to fulfill this obligation.

To prevent the loss of files and other important records, including client files and trust account records, lawyers should maintain an electronic copy of important documents in an off-site location that is updated regularly.[26] Although not required, lawyers may maintain these files solely as electronic files, except in instances where law, court order, or agreement require maintenance of paper copies, and as long as the files are readily accessible and not subject to inadvertent

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[22] Lawyers should consider returning all original documents and documents with intrinsic value created by the lawyer as a result of the representation to clients at the end of representation to avoid this situation.
[23] *See* MODEL RULES OF PROF'L CONDUCT R. 8.4(c) (2018); N.Y. City Bar Ass'n Formal Op. 2015-6 (2015).
[24] *See* MODEL RULES OF PROF'L CONDUCT R. 1.1, 1.3 & 1.4 (2018); N.Y. City Bar Ass'n Formal Op. 2015-6 (2015).
[25] Lawyers should consider including in fee agreements or engagement letters the understandings between the lawyer and the client about how the lawyer will handle documents once the representation is ended. In addition, lawyers should consult statutes, common law, and court rules that may also govern the retention of client files.
[26] MODEL RULES OF PROF'L CONDUCT R. 1.1 (2018); MODEL RULES OF PROF'L CONDUCT R. 1.3 (2018).

modification or degradation.[27] As discussed above, lawyers may also store files "in the cloud" if ethics obligations regarding confidentiality and control of and access to information are met.

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[27] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (May 22, 2017) (Lawyer may send client information over the Internet if lawyer makes reasonable efforts to prevent inadvertent or unauthorized access, but may be required to take special security precautions when required by an agreement with the client or by law, or when the nature of the information requires a higher degree of security); ABA Comm. on Ethics & Prof'l Responsibility, Informal Op. 1127 (1970) (Lawyers may use company that stores attorney files on computer as long as the company is set up so that the material is available only to the particular attorney to whom the files belong and the employees of the company; lawyers must take care to choose an appropriate company that has procedures to ensure confidentiality and to admonish the company that confidentiality of the files must be preserved); State Bar of Ariz. Op. 07-02 (2007) (Lawyer may not destroy original client documents after converting them to electronic records without client consent, but may destroy paper documents if they are only copies); State Bar of Cal. Standing Comm. on Prof'l Responsibility & Conduct 2001-157 (2001) (Electronic records may be insufficient if originals are not accurately reproduced, and some documents cannot be copied by law); Fla. Bar Op. 06-1 (2006) (Lawyers may, but are not required to, store files electronically unless: a statute or rule requires retention of an original document, the original document is the property of the client, or destruction of a paper document adversely affects the client's interests; files stored electronically must be readily reproducible and protected from inadvertent modification, degradation or destruction); Me. Bd. of Overseers Op. 185 (2004) (Lawyers may maintain closed files electronically, rather than paper copies, if they are accessible to the client); Me. Bd. of Overseers Op. 183 (2004) ("If an attorney dispenses with the retention of paper files in favor of computerized records, the attorney must be mindful that the obligation to the client may require the attorney to maintain the means to provide copies of those records in a format that will make them accessible to both the attorney and the client in the future. Because the attorney is obligated to ensure that the client is able to make informed decisions regarding the disposition of the file and also must take care in destroying files to be sure that useful information is retained, an attorney will need to consider how new hardware or software will impact future access to old computerized records."); Mo. Informal Advisory Op. 127 (2009) (Lawyer may keep client's file in exclusively electronic format except documents that are legally significant as originals and intrinsically valuable documents and providing that the appropriate software to access the information is maintained for the time period the file must be retained); State Bar of Mich. Op. R-5 (1989) (File storage via electronic means should be treated carefully to ensure confidentiality by limiting access to law firm personnel); N.J. Advisory Comm. on Prof'l Ethics Decisions Op. 701 (2006) (Documents may be stored electronically if sufficient safeguards to maintain confidentiality of the documents, particularly if they are stored outside the law firm, except for documents that are client property such as original wills, trusts, deeds, executed contracts, corporate bylaws and minutes); N.Y. County Lawyers Ass'n Op. 725 (1998) (General opinion on the ethical obligation to retain closed files, including that it may be proper for a lawyer to retain only electronic copies of a file if "the evidentiary value of such documents will not be unduly impaired by the method of storage"); N.Y. State Bar Ass'n Comm. on Prof'l Ethics Op. 680 (1996) (Although some items in a client's file may be stored electronically, some documents (such as original checkbooks, check stubs, cancelled checks, and bank statements) are required by the rules to be kept in original form; documents stored electronically should be stored in "read-only" form so they cannot be inadvertently destroyed or altered; and records must be readily produced when necessary); N.C. State Bar Op. RPC 234 (1996) (Closed client files may be stored electronically as long as the electronic documents can be converted to paper copies, except for "original documents with legal significance, such as wills, contracts, stock certificates, etc."); S.C. Bar Advisory Op. 02-14 (2002) (General opinion on disposition of closed files when one member of a two-member firm retires, discussing various situations and notes that files may be placed on computer or other electronic media; Note: In South Carolina, the files are the property of the client); S.C. Bar Advisory Op. 98-33 (1998) (The committee declined to give an opinion on electronic retention of closed files as a legal question, but indicated there was no prohibition against retaining documents in electronic format as long as doing so did not adversely affect the client's interests and as long as the lawyer took reasonable precautions to make sure that third parties with access to the electronic records kept the records confidential); Va. State Bar Op. 1818 (2005) (Lawyer can maintain client files in electronic format with no paper copies as long as the method of record retention does not adversely affect the client's interests); Wash. State Bar Ass'n Op. 2023 (2003) (Lawyer may have firm file retention policy in which original documents are provided to the client and the lawyer keeps only electronic copies of file materials as long as documents "with intrinsic value" or that are the property of the client cannot be destroyed without client permission); State Bar of Wis. Op. E-00-3 (2000) (If lawyer has stored files electronically, lawyer should provide

F. Solicitation and Advertising

Lawyers may want to offer legal services to persons affected by a disaster. The existence of a disaster, however, does not excuse compliance with lawyer advertising and solicitation rules.[28] Of particular concern is the possibility of improper solicitation in the wake of a disaster. A lawyer may not solicit disaster victims unless the lawyer complies with Model Rules 7.1 through 7.3.[29] "Live person-to-person contact" that is generally prohibited means "in-person, face-to-face, live telephone and other real-time visual or auditory person-to-person communications, where the person is subject to a direct personal encounter without time for reflection,"[30] and a significant motive for the lawyer's doing so is pecuniary gain.[31] In addition to ethical prohibitions, lawyers should be aware that there may be statutory prohibitions that may apply.[32]

Lawyers may solicit in-person to offer pro bono legal services to disaster victims, because the lawyer's motive does not involve pecuniary gain.[33] Additionally, lawyers may communicate with disaster victims in "targeted" written or recorded electronic material in compliance with Rules 7.1 through 7.3. Lawyers also should be mindful of any additional requirements for written or recorded electronic solicitations imposed by particular jurisdictions.[34]

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client copies on disk at client's request. However, lawyer can bill client for time/expense if required to obtain information in format client wants. Attorney does not need to provide client with internal memos, personal notes, and the like).

[28] *See* MODEL RULES OF PROF'L CONDUCT R. 7.1 – 7.5 (all of these Rules were amended in August 2018).

[29] *See* MODEL RULES OF PROF'L CONDUCT R. 7.3 (2018). *See also* The Florida Bar v. Wolfe, 759 So. 2d 639 (Fla. 2000) (Lawyer suspended for one year for soliciting clients by passing out brochures in affected areas in wake of tornados); State Bar of Cal. Standing Comm. on Prof'l Responsibility & Conduct, Formal Op. 2004-166 (2004) (Solicitation of prospective clients in mass disaster victim chat room is not considered in person solicitation but nevertheless is prohibited because it is "intrusive").

[30] MODEL RULES OF PROF'L CONDUCT R. 7.3 cmt. [2] (2018). Rule 7.3(b) contains some exceptions, and Rule 7.3(c) contains an additional prohibition. Both should be consulted.

[31] *Id.*

[32] *See, e.g.*, FLA. STAT. §877.02 (Prohibiting solicitation on behalf of lawyers by hospitals, police, tow truck operators, insurance adjusters); 49 U.S.C. §1136(g)(2) (Prohibiting lawyer solicitation within 45 days of an air transportation accident).

[33] MODEL RULES OF PROF'L CONDUCT R. 7.3(a); La. Bd. of Ethics Op. 05-RPCC-005 (2005) (Lawyer may solicit disaster victims in person to provide pro bono legal services). Providing pro bono legal services is encouraged by, inter alia, Model Rules 6.1 and 6.2.

[34] *See, e.g.*, Rules Regulating the Fla. Bar R. 4-7.18(b)(2) (requiring contrasting "advertisement" mark on envelope and enclosures; statement of qualifications and experience; information on where the lawyer obtained the information prompting the written solicitation; and specified first sentence, among others).

G. Out-Of-State Lawyers Providing Representation to Disaster Victims

Lawyers practicing in jurisdictions unaffected by the disaster who wish to assist by providing legal services to disaster victims must consider rules regulating temporary multijurisdictional practice.[35] Out-of-state lawyers may provide representation to disaster victims in the affected jurisdiction only when permitted by that jurisdiction's law or rules, or by order of the jurisdiction's highest court.

The ABA Model Court Rule on Provision of Legal Services Following Determination of Major Disaster[36] provides that the Supreme Court of the affected jurisdiction must declare a major disaster and issue an order that allows lawyers in good standing from another jurisdiction to temporarily provide pro bono legal services in the affected jurisdiction through a non-profit bar association, pro bono program, legal services program, or other organization designated by the courts.[37] The Model Court Rule also requires those lawyers to register with the courts of the affected jurisdiction, and subjects those lawyers to discipline in the affected jurisdiction.[38]

Conclusion

Lawyers must be prepared to deal with disasters. Foremost among a lawyer's ethical obligations are those to existing clients, particularly in maintaining communication. Lawyers must also protect documents, funds, and other property the lawyer is holding for clients or third parties.

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[35] MODEL RULES OF PROF'L CONDUCT R. 5.5 (c), cmt. [14] (2018): "Lawyers desiring to provide pro bono legal services on a temporary basis in a jurisdiction that has been affected by a major disaster, but in which they are not otherwise authorized to practice law, as well as lawyers from the affected jurisdiction who seek to practice law temporarily in another jurisdiction, but in which they are not otherwise authorized to practice law, should consult the Model Court Rule on Provision of Legal Services Following Determination of Major Disaster."
Most states have adopted some form of ABA Model Rule 5.5 on Multijurisdictional Practice. A chart on state implementation of ABA Multijurisdictional Practice Policies compiled by the ABA may be found at: https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/recommendations.authcheckdam.pdf.

[36] ABA MODEL COURT RULE ON PROVISION OF LEGAL SERVICES FOLLOWING DETERMINATION OF MAJOR DISASTER, *available at* https://www.americanbar.org/content/dam/aba/images/disaster/model_court_rule.pdf (last visited Sept. 7, 2018). The ABA Chart on State Implementation of ABA Model Court Rule on Provision of Legal Services Following Determination of Major Disaster can be found at: https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/katrina_chart.authcheckdam.pdf

[37] Providing pro bono legal services in this situation would assist the lawyer in meeting the suggested goal of 50 hours per year set forth in Model Rule 6.1(a).

[38] As noted above, the Supreme Court of Texas issued an emergency order in 2017 after Hurricane Harvey following the ABA Model Court Order. *See supra* note 18.

By proper advance preparation and taking advantage of available technology during recovery efforts, lawyers will reduce the risk of violating professional obligations after a disaster.

Dissent: Keith R. Fisher dissents.

AMERICAN BAR ASSOCIATION

STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 483 **October 17, 2018**

Lawyers' Obligations After an Electronic Data Breach or Cyberattack

Model Rule 1.4 requires lawyers to keep clients "reasonably informed" about the status of a matter and to explain matters "to the extent reasonably necessary to permit a client to make an informed decision regarding the representation." Model Rules 1.1, 1.6, 5.1 and 5.3, as amended in 2012, address the risks that accompany the benefits of the use of technology by lawyers. When a data breach occurs involving, or having a substantial likelihood of involving, material client information, lawyers have a duty to notify clients of the breach and to take other reasonable steps consistent with their obligations under these Model Rules.

Introduction[1]

Data breaches and cyber threats involving or targeting lawyers and law firms are a major professional responsibility and liability threat facing the legal profession. As custodians of highly sensitive information, law firms are inviting targets for hackers.[2] In one highly publicized incident, hackers infiltrated the computer networks at some of the country's most well-known law firms, likely looking for confidential information to exploit through insider trading schemes.[3] Indeed, the data security threat is so high that law enforcement officials regularly divide business entities into two categories: those that have been hacked and those that will be.[4]

In Formal Opinion 477R, this Committee explained a lawyer's ethical responsibility to use reasonable efforts when communicating client confidential information using the Internet.[5] This

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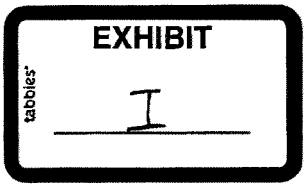
[1] This opinion is based on the ABA Model Rules of Professional Conduct as amended by the ABA House of Delegates through August 2018. The laws, court rules, regulations, rules of professional conduct and opinions promulgated in individual jurisdictions are controlling.

[2] *See, e.g.*, Dan Steiner, *Hackers Are Aggressively Targeting Law Firms' Data* (Aug. 3, 2017), https://www.cio.com (explaining that "[f]rom patent disputes to employment contracts, law firms have a lot of exposure to sensitive information. Because of their involvement, confidential information is stored on the enterprise systems that law firms use. . . . This makes them a juicy target for hackers that want to steal consumer information and corporate intelligence."). *See also Criminal-Seeking-Hacker' Requests Network Breach for Insider Trading*, Private Industry Notification 160304-01, FBI, CYBER DIVISION (Mar. 4, 2016).

[3] Nicole Hong & Robin Sidel, *Hackers Breach Law Firms, Including Cravath and Weil Gotshal*, WALL ST. J. (Mar. 29, 2016), https://www.wsj.com/articles/hackers-breach-cravath-swaine-other-big-law-firms-1459293504.

[4] Robert S. Mueller, III, *Combatting Threats in the Cyber World Outsmarting Terrorists, Hackers and Spies*, FBI (Mar. 1, 2012), https://archives.fbi.gov/archives/news/speeches/combating-threats-in-the-cyber-world-outsmarting-terrorists-hackers-and-spies.

[5] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017) ("Securing Communication of Protected Client Information").



opinion picks up where Opinion 477R left off, and discusses an attorney's ethical obligations when a data breach exposes client confidential information. This opinion focuses on an attorney's ethical obligations after a data breach,[6] and it addresses only data breaches that involve information relating to the representation of a client. It does not address other laws that may impose post-breach obligations, such as privacy laws or other statutory schemes that law firm data breaches might also implicate. Each statutory scheme may have different post-breach obligations, including different notice triggers and different response obligations. Both the triggers and obligations in those statutory schemes may overlap with the ethical obligations discussed in this opinion. And, as a matter of best practices, attorneys who have experienced a data breach should review all potentially applicable legal response obligations. However, compliance with statutes such as state breach notification laws, HIPAA, or the Gramm-Leach-Bliley Act does not necessarily achieve compliance with ethics obligations. Nor does compliance with lawyer regulatory rules *per se* represent compliance with breach response laws. As a matter of best practices, lawyers who have suffered a data breach should analyze compliance separately under every applicable law or rule.

Compliance with the obligations imposed by the Model Rules of Professional Conduct, as set forth in this opinion, depends on the nature of the cyber incident, the ability of the attorney to know about the facts and circumstances surrounding the cyber incident, and the attorney's roles, level of authority, and responsibility in the law firm's operations.[7]

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[6] The Committee recognizes that lawyers provide legal services to clients under a myriad of organizational structures and circumstances. The Model Rules of Professional Conduct refer to the various structures as a "firm." A "firm" is defined in Rule 1.0(c) as "a lawyer or lawyers in a law partnership, professional corporation, sole proprietorship or other association authorized to practice law; or lawyers employed in a legal services organization or the legal department of a corporation or other organization." How a lawyer complies with the obligations discussed in this opinion will vary depending on the size and structure of the firm in which a lawyer is providing client representation and the lawyer's position in the firm. *See* MODEL RULES OF PROF'L CONDUCT R. 5.1 (2018) (Responsibilities of Partners, Managers, and Supervisory Lawyers); MODEL RULES OF PROF'L CONDUCT R. 5.2 (2018) (Responsibility of a Subordinate Lawyers); and MODEL RULES OF PROF'L CONDUCT R. 5.3 (2018) (Responsibility Regarding Nonlawyer Assistance).

[7] In analyzing how to implement the professional responsibility obligations set forth in this opinion, lawyers may wish to consider obtaining technical advice from cyber experts. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017) ("Any lack of individual competence by a lawyer to evaluate and employ safeguards to protect client confidences may be addressed through association with another lawyer or expert, or by education.") *See also, e.g., Cybersecurity Resources*, ABA Task Force on Cybersecurity, https://www.americanbar.org/groups/cybersecurity/resources.html (last visited Oct. 5, 2018).

I. Analysis

A. Duty of Competence

Model Rule 1.1 requires that "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."[8] The scope of this requirement was clarified in 2012, when the ABA recognized the increasing impact of technology on the practice of law and the obligation of lawyers to develop an understanding of that technology. Comment [8] to Rule 1.1 was modified in 2012 to read:

> To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, *including the benefits and risks associated with relevant technology*, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject. (Emphasis added.)[9]

In recommending the change to Rule 1.1's Comment, the ABA Commission on Ethics 20/20 explained:

> Model Rule 1.1 requires a lawyer to provide competent representation, and Comment [6] [renumbered as Comment [8]] specifies that, to remain competent, lawyers need to 'keep abreast of changes in the law and its practice.' The Commission concluded that, in order to keep abreast of changes in law practice in a digital age, lawyers necessarily need to understand basic features of relevant technology and that this aspect of competence should be expressed in the Comment. For example, a lawyer would have difficulty providing competent legal services in today's environment without knowing how to use email or create an electronic document.[10]

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[8] MODEL RULES OF PROF'L CONDUCT R. 1.1 (2018).

[9] A LEGISLATIVE HISTORY: THE DEVELOPMENT OF THE ABA MODEL RULES OF PROFESSIONAL CONDUCT, 1982-2013, at 43 (Art Garwin ed., 2013).

[10] ABA COMMISSION ON ETHICS 20/20 REPORT 105A (Aug. 2012), http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20120808_revised_resolution_105a_as_amended.authcheckdam.pdf. The 20/20 Commission also noted that modification of Comment [6] did not change the lawyer's substantive duty of competence: "Comment [6] already encompasses an obligation to remain aware of changes in technology that affect law practice, but the Commission concluded that making this explicit, by addition of the phrase 'including the benefits and risks associated with relevant technology,' would offer greater clarity in this area and emphasize the importance of technology to modern law practice. The proposed amendment, which appears in a Comment, does not impose any new obligations on lawyers. Rather, the amendment is intended to serve as a reminder to lawyers that they should remain aware of technology, including the benefits and risks associated with it, as part of a lawyer's general ethical duty to remain competent."

In the context of a lawyer's post-breach responsibilities, both Comment [8] to Rule 1.1 and the 20/20 Commission's thinking behind it require lawyers to understand technologies that are being used to deliver legal services to their clients. Once those technologies are understood, a competent lawyer must use and maintain those technologies in a manner that will reasonably safeguard property and information that has been entrusted to the lawyer. A lawyer's competency in this regard may be satisfied either through the lawyer's own study and investigation or by employing or retaining qualified lawyer and nonlawyer assistants.[11]

1. Obligation to Monitor for a Data Breach

Not every cyber episode experienced by a lawyer is a data breach that triggers the obligations described in this opinion. A data breach for the purposes of this opinion means a data event where material client confidential information is misappropriated, destroyed or otherwise compromised, or where a lawyer's ability to perform the legal services for which the lawyer is hired is significantly impaired by the episode.

Many cyber events occur daily in lawyers' offices, but they are not a data breach because they do not result in actual compromise of material client confidential information. Other episodes rise to the level of a data breach, either through exfiltration/theft of client confidential information or through ransomware, where no client information is actually accessed or lost, but where the information is blocked and rendered inaccessible until a ransom is paid. Still other compromises involve an attack on a lawyer's systems, destroying the lawyer's infrastructure on which confidential information resides and incapacitating the attorney's ability to use that infrastructure to perform legal services.

Model Rules 5.1 and 5.3 impose upon lawyers the obligation to ensure that the firm has in effect measures giving reasonable assurance that all lawyers and staff in the firm conform to the Rules of Professional Conduct. Model Rule 5.1 Comment [2], and Model Rule 5.3 Comment [1] state that lawyers with managerial authority within a firm must make reasonable efforts to establish

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[11] MODEL RULES OF PROF'L CONDUCT R. 5.3 (2018); ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017); ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 08-451 (2018); *See also* JILL D. RHODES & ROBERT S. LITT, THE ABA CYBERSECURITY HANDBOOK: A RESOURCE FOR ATTORNEYS, LAW FIRMS, AND BUSINESS PROFESSIONALS 124 (2d ed. 2018) [hereinafter ABA CYBERSECURITY HANDBOOK].

internal policies and procedures designed to provide reasonable assurance that all lawyers and staff in the firm will conform to the Rules of Professional Conduct. Model Rule 5.1 Comment [2] further states that "such policies and procedures include those designed to detect and resolve conflicts of interest, identify dates by which actions must be taken in pending matters, account for client funds and property and ensure that inexperienced lawyers are properly supervised."

Applying this reasoning, and based on lawyers' obligations (i) to use technology competently to safeguard confidential information against unauthorized access or loss, and (ii) to supervise lawyers and staff, the Committee concludes that lawyers must employ reasonable efforts to monitor the technology and office resources connected to the internet, external data sources, and external vendors providing services relating to data[12] and the use of data. Without such a requirement, a lawyer's recognition of any data breach could be relegated to happenstance --- and the lawyer might not identify whether a breach has occurred,[13] whether further action is warranted,[14] whether employees are adhering to the law firm's cybersecurity policies and procedures so that the lawyers and the firm are in compliance with their ethical duties,[15] and how and when the lawyer must take further action under other regulatory and legal provisions.[16] Thus, just as lawyers must safeguard and monitor the security of paper files and actual client property, lawyers utilizing technology have the same obligation to safeguard and monitor the security of electronically stored client property and information.[17]

While lawyers must make reasonable efforts to monitor their technology resources to detect a breach, an ethical violation does not necessarily occur if a cyber-intrusion or loss of electronic information is not immediately detected, because cyber criminals might successfully hide their

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[12] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 08-451 (2008).

[13] Fredric Greene, *Cybersecurity Detective Controls—Monitoring to Identify and Respond to Threats*, ISACA J., Vol. 5, 1025 (2015), *available at* https://www.isaca.org/Journal/archives/2015/Volume-5/Pages/cybersecurity-detective-controls.aspx (noting that "[d]etective controls are a key component of a cybersecurity program in providing visibility into malicious activity, breaches and attacks on an organization's IT environment.").

[14] MODEL RULES OF PROF'L CONDUCT R. 1.6(c) (2018); MODEL RULES OF PROF'L CONDUCT R. 1.15 (2018).

[15] *See also* MODEL RULES OF PROF'L CONDUCT R. 5.1 & 5.3 (2018).

[16] The importance of monitoring to successful cybersecurity efforts is so critical that in 2015, Congress passed the Cybersecurity Information Sharing Act of 2015 (CISA) to authorize companies to monitor and implement defensive measures on their information systems, and to foreclose liability for such monitoring under CISA. AUTOMATED INDICATOR SHARING, https://www.us-cert.gov/ais (last visited Oct. 5, 2018); *See also* National Cyber Security Centre "Ten Steps to Cyber Security" [Step 8: Monitoring] (Aug. 9, 2016), https://www.ncsc.gov.uk/guidance/10-steps-cyber-security.

[17] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 477R (2017).

intrusion despite reasonable or even extraordinary efforts by the lawyer. Thus, as is more fully explained below, the potential for an ethical violation occurs when a lawyer does not undertake reasonable efforts to avoid data loss or to detect cyber-intrusion, and that lack of reasonable effort is the cause of the breach.

2. Stopping the Breach and Restoring Systems

When a breach of protected client information is either suspected or detected, Rule 1.1 requires that the lawyer act reasonably and promptly to stop the breach and mitigate damage resulting from the breach. How a lawyer does so in any particular circumstance is beyond the scope of this opinion. As a matter of preparation and best practices, however, lawyers should consider proactively developing an incident response plan with specific plans and procedures for responding to a data breach.[18] The decision whether to adopt a plan, the content of any plan, and actions taken to train and prepare for implementation of the plan, should be made before a lawyer is swept up in an actual breach. "One of the benefits of having an incident response capability is that it supports responding to incidents systematically (i.e., following a consistent incident handling methodology) so that the appropriate actions are taken. Incident response plans help personnel to minimize loss or theft of information and disruption of services caused by incidents."[19] While every lawyer's response plan should be tailored to the lawyer's or the law firm's specific practice, as a general matter incident response plans share common features:

> The primary goal of any incident response plan is to have a process in place that will allow the firm to promptly respond in a coordinated manner to any type of security incident or cyber intrusion. The incident response process should promptly: identify and evaluate any potential network anomaly or intrusion; assess its nature and scope; determine if any data or information may have been accessed or compromised; quarantine the threat or malware; prevent the exfiltration of information from the firm; eradicate the malware, and restore the integrity of the firm's network.
>
> Incident response plans should identify the team members and their backups; provide the means to reach team members at any time an intrusion is reported, and

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[18] *See* ABA CYBERSECURITY HANDBOOK, *supra* note 11, at 202 (explaining the utility of large law firms adopting "an incident response plan that details who has ownership of key decisions and the process to follow in the event of an incident.").

[19] *NIST Computer Security Incident Handling Guide*, at 6 (2012), https://nvlpubs.nist.gov/nistpubs/specialpublications/nist.sp.800-61r2.pdf.

> define the roles of each team member. The plan should outline the steps to be taken at each stage of the process, designate the team member(s) responsible for each of those steps, as well as the team member charged with overall responsibility for the response.[20]

Whether or not the lawyer impacted by a data breach has an incident response plan in place, after taking prompt action to stop the breach, a competent lawyer must make all reasonable efforts to restore computer operations to be able again to service the needs of the lawyer's clients. The lawyer may do so either on her own, if qualified, or through association with experts. This restoration process provides the lawyer with an opportunity to evaluate what occurred and how to prevent a reoccurrence consistent with the obligation under Model Rule 1.6(c) that lawyers "make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of the client."[21] These reasonable efforts could include (i) restoring the technology systems as practical, (ii) the implementation of new technology or new systems, or (iii) the use of no technology at all if the task does not require it, depending on the circumstances.

3. Determining What Occurred

The Model Rules do not impose greater or different obligations on a lawyer as a result of a breach involving client information, regardless of whether the breach occurs through electronic or physical means. Just as a lawyer would need to assess which paper files were stolen from the lawyer's office, so too lawyers must make reasonable attempts to determine whether electronic files were accessed, and if so, which ones. A competent attorney must make reasonable efforts to determine what occurred during the data breach. A post-breach investigation requires that the lawyer gather sufficient information to ensure the intrusion has been stopped and then, to the extent reasonably possible, evaluate the data lost or accessed. The information gathered in a post-breach investigation is necessary to understand the scope of the intrusion and to allow for accurate disclosure to the client consistent with the lawyer's duty of communication and honesty under

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[20] Steven M. Puiszis, *Prevention and Response: A Two-Pronged Approach to Cyber Security and Incident Response Planning*, THE PROF'L LAWYER, Vol. 24, No. 3 (Nov. 2017).

[21] We discuss Model Rule 1.6(c) further below. But in restoring computer operations, lawyers should consider whether the lawyer's computer systems need to be upgraded or otherwise modified to address vulnerabilities, and further, whether some information is too sensitive to continue to be stored electronically.

Model Rules 1.4 and 8.4(c).[22] Again, how a lawyer actually makes this determination is beyond the scope of this opinion. Such protocols may be a part of an incident response plan.

B. Duty of Confidentiality

In 2012, amendments to Rule 1.6 modified both the Rule and the commentary about a lawyer's efforts that are required to preserve the confidentiality of information relating to the representation of a client. Model Rule 1.6(a) requires that "A lawyer shall not reveal information relating to the representation of a client" unless certain circumstances arise.[23] The 2012 modification added a duty in paragraph (c) that: "A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."[24]

Amended Comment [18] explains:

> Paragraph (c) requires a lawyer to act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision. *See* Rules 1.1, 5.1 and 5.3. The unauthorized access to, or the inadvertent or unauthorized disclosure of, information relating to the representation of a client does not constitute a violation of paragraph (c) if the lawyer has made reasonable efforts to prevent the access or disclosure.

Recognizing the necessity of employing a fact-based analysis, Comment [18] to Model Rule 1.6(c) includes nonexclusive factors to guide lawyers in making a "reasonable efforts" determination. Those factors include:

- the sensitivity of the information,
- the likelihood of disclosure if additional safeguards are not employed,
- the cost of employing additional safeguards,
- the difficulty of implementing the safeguards, and

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[22] The rules against dishonesty and deceit may apply, for example, where the lawyer's failure to make an adequate disclosure --- or any disclosure at all --- amounts to deceit by silence. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 4.1 cmt. [1] (2018) ("Misrepresentations can also occur by partially true but misleading statements or omissions that are the equivalent of affirmative false statements.").

[23] MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2018).

[24] *Id.* at (c).

- the extent to which the safeguards adversely affect the lawyer's ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use).[25]

As this Committee recognized in ABA Formal Opinion 477R:

> At the intersection of a lawyer's competence obligation to keep "abreast of knowledge of the benefits and risks associated with relevant technology," and confidentiality obligation to make "reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client," lawyers must exercise reasonable efforts when using technology in communicating about client matters. What constitutes reasonable efforts is not susceptible to a hard and fast rule, but rather is contingent upon a set of factors.

As discussed above and in Formal Opinion 477R, an attorney's competence in preserving a client's confidentiality is not a strict liability standard and does not require the lawyer to be invulnerable or impenetrable.[26] Rather, the obligation is one of reasonable efforts. Rule 1.6 is not violated even if data is lost or accessed if the lawyer has made reasonable efforts to prevent the loss or access.[27] As noted above, this obligation includes efforts to monitor for breaches of client confidentiality. The nature and scope of this standard is addressed in the ABA Cybersecurity Handbook:

> Although security is relative, a legal standard for "reasonable" security is emerging. That standard rejects requirements for specific security measures (such as firewalls, passwords, or the like) and instead adopts a fact-specific approach to business security obligations that requires a "process" to assess risks, identify and implement appropriate security measures responsive to those risks, verify that the measures are effectively implemented, and ensure that they are continually updated in response to new developments.[28]

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[25] MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. [18] (2018). "The [Ethics 20/20] Commission examined the possibility of offering more detailed guidance about the measures that lawyers should employ. The Commission concluded, however, that technology is changing too rapidly to offer such guidance and that the particular measures lawyers should use will necessarily change as technology evolves and as new risks emerge and new security procedures become available." ABA COMMISSION REPORT 105A, *supra* note 9, at 5.

[26] ABA CYBERSECURITY HANDBOOK, *supra* note 11, at 122.

[27] MODEL RULES OF PROF'L CONDUCT R. 1.6, cmt. [18] (2018) ("The unauthorized access to, or the inadvertent or unauthorized disclosure of, information relating to the representation of a client does not constitute a violation of paragraph (c) if the lawyer has made reasonable efforts to prevent the access or disclosure.")

[28] ABA CYBERSECURITY HANDBOOK, *supra* note 11, at 73.

Finally, Model Rule 1.6 permits a lawyer to reveal information relating to the representation of a client if the disclosure is impliedly authorized in order to carry out the representation. Such disclosures are permitted if the lawyer reasonably believes that disclosure: (1) is impliedly authorized and will advance the interests of the client in the representation, and (2) will not affect a material interest of the client adversely.[29] In exercising this discretion to disclose information to law enforcement about the data breach, the lawyer must consider: (i) whether the client would object to the disclosure; (ii) whether the client would be harmed by the disclosure; and (iii) whether reporting the theft would benefit the client by assisting in ending the breach or recovering stolen information. Even then, without consent, the lawyer may disclose only such information as is reasonably necessary to assist in stopping the breach or recovering the stolen information.

C. Lawyer's Obligations to Provide Notice of Data Breach

When a lawyer knows or reasonably should know a data breach has occurred, the lawyer must evaluate notice obligations. Due to record retention requirements of Model Rule 1.15, information compromised by the data breach may belong or relate to the representation of a current client or former client.[30] We address each below.

1. Current Client

Communications between a lawyer and current client are addressed generally in Model Rule 1.4. Rule 1.4(a)(3) provides that a lawyer must "keep the client reasonably informed about the status of the matter." Rule 1.4(b) provides: "A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." Under these provisions, an obligation exists for a lawyer to communicate with current clients about a data breach.[31]

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[29] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 01-421(2001) (disclosures to insurer in bills when lawyer representing insured).

[30] This opinion addresses only obligations to clients and former clients. Data breach, as used in this opinion, is limited to client confidential information. We do not address ethical duties, if any, to third parties.

[31] Relying on Rule 1.4 generally, the New York State Bar Committee on Professional Ethics concluded that a lawyer must notify affected clients of information lost through an online data storage provider. N.Y. State Bar Ass'n Op. 842 (2010) (Question 10: "If the lawyer learns of any breach of confidentiality by the online storage provider, then the lawyer must investigate whether there has been any breach of his or her own clients' confidential information,

Our conclusion here is consistent with ABA Formal Ethics Opinion 95-398 where this Committee said that notice must be given to clients if a breach of confidentiality was committed by or through a third-party computer vendor or other service provider. There, the Committee concluded notice to the client of the breach may be required under 1.4(b) for a "serious breach."[32] The Committee advised:

> Where the unauthorized release of confidential information could reasonably be viewed as a significant factor in the representation, for example where it is likely to affect the position of the client or the outcome of the client's legal matter, disclosure of the breach would be required under Rule 1.4(b).[33]

A data breach under this opinion involves the misappropriation, destruction or compromise of client confidential information, or a situation where a lawyer's ability to perform the legal services for which the lawyer was hired is significantly impaired by the event. Each of these scenarios is one where a client's interests have a reasonable possibility of being negatively impacted. When a data breach occurs involving, or having a substantial likelihood of involving, material client confidential information a lawyer has a duty to notify the client of the breach. As noted in ABA Formal Opinion 95-398, a data breach requires notice to the client because such notice is an integral part of keeping a "client reasonably informed about the status of the matter" and the lawyer should provide information as would be "reasonably necessary to permit the client to make informed decisions regarding the representation" within the meaning of Model Rule 1.4.[34]

The strong client protections mandated by Model Rule 1.1, 1.6, 5.1 and 5.3, particularly as they were amended in 2012 to account for risks associated with the use of technology, would be compromised if a lawyer who experiences a data breach that impacts client confidential information is permitted to hide those events from their clients. And in view of the duties imposed by these other Model Rules, Model Rule 1.4's requirement to keep clients "reasonably informed about the status" of a matter would ring hollow if a data breach was somehow excepted from this responsibility to communicate.

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notify any affected clients, and discontinue use of the service unless the lawyer receives assurances that any security issues have been sufficiently remediated.") (*citations omitted*).

[32] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 95-398 (1995).

[33] *Id.*

[34] MODEL RULES OF PROF'L CONDUCT R. 1.4(b) (2018).

Model Rule 1.15(a) provides that a lawyer shall hold "property" of clients "in connection with a representation separate from the lawyer's own property." Funds must be kept in a separate account, and "[o]ther property shall be identified as such and appropriately safeguarded." Model Rule 1.15(a) also provides that, "Complete records of such account funds and other property shall be kept by the lawyer . . . ." Comment [1] to Model Rule 1.15 states:

> A lawyer should hold property of others with the care required of a professional fiduciary. Securities should be kept in a safe deposit box, except when some other form of safekeeping is warranted by special circumstances. All property that is the property of clients or third persons, including prospective clients, must be kept separate from the lawyer's business and personal property.

An open question exists whether Model Rule 1.15's reference to "property" includes information stored in electronic form. Comment [1] uses as examples "securities" and "property" that should be kept separate from the lawyer's "business and personal property." That language suggests Rule 1.15 is limited to tangible property which can be physically segregated. On the other hand, many courts have moved to electronic filing and law firms routinely use email and electronic document formats to image or transfer information. Reading Rule 1.15's safeguarding obligation to apply to hard copy client files but not electronic client files is not a reasonable reading of the Rule.

Jurisdictions that have addressed the issue are in agreement. For example, Arizona Ethics Opinion 07-02 concluded that client files may be maintained in electronic form, with client consent, but that lawyers must take reasonable precautions to safeguard the data under the duty imposed in Rule 1.15. The District of Columbia Formal Ethics Opinion 357 concluded that, "Lawyers who maintain client records solely in electronic form should take reasonable steps (1) to ensure the continued availability of the electronic records in an accessible form during the period for which they must be retained and (2) to guard against the risk of unauthorized disclosure of client information."

The Committee has engaged in considerable discussion over whether Model Rule 1.15 and, taken together, the technology amendments to Rules 1.1, 1.6, and 5.3 impliedly impose an obligation on a lawyer to notify a current client of a data breach. We do not have to decide that question in the absence of concrete facts. We reiterate, however, the obligation to inform the client does exist under Model Rule 1.4.

2. Former Client

Model Rule 1.9(c) requires that "A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter . . . reveal information relating to the representation except as these Rules would permit or require with respect to a client."[35] When electronic "information relating to the representation" of a former client is subject to unauthorized access, disclosure, or destruction, the Model Rules provide no direct guidance on a lawyer's obligation to notify the former client. Rule 1.9(c) provides that a lawyer "shall not . . . reveal" the former client's information. It does not describe what steps, if any, a lawyer should take if such information is revealed. The Committee is unwilling to require notice to a former client as a matter of legal ethics in the absence of a black letter provision requiring such notice.[36]

Nevertheless, we note that clients can make an informed waiver of the protections in Rule 1.9.[37] We also note that Rule 1.16(d) directs that lawyers should return "papers and property" to clients at the conclusion of the representation, which has commonly been understood to include the client's file, in whatever form it is held. Rule 1.16(d) also has been interpreted as permitting lawyers to establish appropriate data destruction policies to avoid retaining client files and property indefinitely.[38] Therefore, as a matter of best practices, lawyers are encouraged to reach agreement with clients before conclusion, or at the termination, of the relationship about how to handle the client's electronic information that is in the lawyer's possession.

Absent an agreement with the former client lawyers are encouraged to adopt and follow a paper and electronic document retention schedule, which meets all applicable laws and rules, to reduce the amount of information relating to the representation of former clients that the lawyers retain. In addition, lawyers should recognize that in the event of a data breach involving former client information, data privacy laws, common law duties of care, or contractual arrangements with

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[35] MODEL RULES OF PROF'L CONDUCT R. 1.9(c)(2) (2018).
[36] *See* Discipline of Feland, 2012 ND 174, ¶ 19, 820 N.W.2d 672 (Rejecting respondent's argument that the court should engraft an additional element of proof in a disciplinary charge because "such a result would go beyond the clear language of the rule and constitute amendatory rulemaking within an ongoing disciplinary proceeding.").
[37] *See* MODEL RULES OF PROF'L CONDUCT R. 1.9, cmt. [9] (2018).
[38] *See* ABA Ethics Search Materials on Client File Retention, https://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/piles_of_files_2008.pdf (last visited Oct.15, 2018).

the former client relating to records retention, may mandate notice to former clients of a data breach. A prudent lawyer will consider such issues in evaluating the response to the data breach in relation to former clients.[39]

3. Breach Notification Requirements

The nature and extent of the lawyer's communication will depend on the type of breach that occurs and the nature of the data compromised by the breach. Unlike the "safe harbor" provisions of Comment [18] to Model Rule 1.6, if a post-breach obligation to notify is triggered, a lawyer must make the disclosure irrespective of what type of security efforts were implemented prior to the breach. For example, no notification is required if the lawyer's office file server was subject to a ransomware attack but no information relating to the representation of a client was inaccessible for any material amount of time, or was not accessed by or disclosed to unauthorized persons. Conversely, disclosure will be required if material client information was actually or reasonably suspected to have been accessed, disclosed or lost in a breach.

The disclosure must be sufficient to provide enough information for the client to make an informed decision as to what to do next, if anything. In a data breach scenario, the minimum disclosure required to all affected clients under Rule 1.4 is that there has been unauthorized access to or disclosure of their information, or that unauthorized access or disclosure is reasonably suspected of having occurred. Lawyers must advise clients of the known or reasonably ascertainable extent to which client information was accessed or disclosed. If the lawyer has made reasonable efforts to ascertain the extent of information affected by the breach but cannot do so, the client must be advised of that fact.

In addition, and as a matter of best practices, a lawyer also should inform the client of the lawyer's plan to respond to the data breach, from efforts to recover information (if feasible) to steps being taken to increase data security.

The Committee concludes that lawyers have a continuing duty to keep clients reasonably apprised of material developments in post-breach investigations affecting the clients'

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[39] *Cf.* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 482 (2018), at 8-10 (discussing obligations regarding client files lost or destroyed during disasters like hurricanes, floods, tornadoes, and fires).

information.[40] Again, specific advice on the nature and extent of follow up communications cannot be provided in this opinion due to the infinite number of variable scenarios.

If personally identifiable information of clients or others is compromised as a result of a data beach, the lawyer should evaluate the lawyer's obligations under state and federal law. All fifty states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands have statutory breach notification laws.[41] Those statutes require that private or governmental entities notify individuals of breaches involving loss or disclosure of personally identifiable information.[42] Most breach notification laws specify who must comply with the law, define "personal information," define what constitutes a breach, and provide requirements for notice.[43] Many federal and state agencies also have confidentiality and breach notification requirements.[44] These regulatory schemes have the potential to cover individuals who meet particular statutory notice triggers, irrespective of the individual's relationship with the lawyer. Thus, beyond a Rule 1.4 obligation, lawyers should evaluate whether they must provide a statutory or regulatory data breach notification to clients or others based upon the nature of the information in the lawyer's possession that was accessed by an unauthorized user.[45]

III. Conclusion

Even lawyers who, (i) under Model Rule 1.6(c), make "reasonable efforts to prevent the . . . unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client," (ii) under Model Rule 1.1, stay abreast of changes in technology, and (iii) under Model Rules 5.1 and 5.3, properly supervise other lawyers and third-party electronic-information storage vendors, may suffer a data breach. When they do, they have a duty to notify clients of the data

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[40] State Bar of Mich. Op. RI-09 (1991).

[41] National Conference of State Legislatures, *Security Breach Notification Laws* (Sept. 29, 2018), http://www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx.

[42] *Id.*

[43] *Id.*

[44] ABA CYBERSECURITY HANDBOOK, *supra* note 11, at 65.

[45] Given the broad scope of statutory duties to notify, lawyers would be well served to actively manage the amount of confidential and or personally identifiable information they store beyond any ethical, statutory, or other legal obligation to do so. Lawyers should implement, and follow, a document retention policy that comports with Model Rule 1.15 and evaluate ways to limit receipt, possession and/or retention of confidential or personally identifiable information during or after an engagement.

breach under Model Rule 1.4 in sufficient detail to keep clients "reasonably informed" and with an explanation "to the extent necessary to permit the client to make informed decisions regarding the representation."

NOTES