Legal Ethics in the Context of Negotiations

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Most of the Rules of Professional Conduct (RPCs) are drafted in the context of litigation and other contested matters, and not in the context of transactional matters and negotiations. This article examines some of the RPCs frequently encountered in the context of negotiations. In particular, the article examines a few RPCs referring to a lawyer's obligations to make truthful statements when negotiating on behalf of clients, and to disclose information to third parties to prevent certain "bad acts" of clients.

When Representing a Client, I Cannot Tell a Lie

About Material Facts

A lawyer cannot lie about *material* facts. RPC 4.1(a)(1) states that: "In representing a client, a lawyer shall not knowingly make a false statement of material fact or law to a third person."[1] The two key terms in this rule are "knowingly" and "material facts."

RPC 1.0(f) defines "knowingly" as "actual knowledge of the fact in question. A person's knowledge may be inferred from circumstances." Thus, there is no violation of RPC 4.1(a) if the lawyer does not know that his or her statement is false. Consider the following example.

Example #1: A lawyer represents a client selling a business. In response to a buyer's request for due diligence, the client sends his lawyer unaudited financial statements with instructions to forward them to an interested buyer. The financial statements are false, and show inflated income. The lawyer is conveying false information from his client to the other party, but if the lawyer does not know the information is false, he is not knowingly making a false statement.

The term "material fact" is not defined in the RPCs. A fact is material if it has real importance or great consequence,[2] one that goes to the heart of the matter.[3] That is, "a fact is material when, if the representation had not been made, the contract or transaction would not have been entered into. Conversely, a representation is not material when it appears that the transaction would have been entered into notwithstanding it."[4] Consider the following two examples to distinguish between material and immaterial facts.

Example #2: A buyer wants to purchase an office building for its rental income. When representing the seller of an office building, a lawyer states to the buyer that the building sits on two acres of land when she knows that the actual size is 1.90 acres. The size of the land in this context is probably an immaterial fact because the buyer seeks the rental income and the transaction would probably happen regardless of the size of the land.

Example #3: When representing the seller of vacant land, a lawyer states to the buyer that there are five acres of vacant land when he knows that the actual size of the land is 4.90 acres. The size of the land in this context may be a material fact if the buyer has indicated that he intends to develop the vacant land into five one-acre lots in accordance with applicable land use laws. The transaction may not happen, or certainly would not happen at the same price, if the buyer knew that he could subdivide the land into only four instead of five lots, or that he could subdivide the land into five lots only if he bears the additional cost of seeking applicable variances.

About the Law

RPC 4.1(a)(1) states that "a lawyer shall not knowingly make a false statement of material fact or law to a third person." The rule prohibits a lawyer from knowingly misstating the law to another person, including another lawyer, because the other person may rely on the misstatement.[5] In this

regard, two authorities on legal ethics have written:

> [W]hen one lawyer addresses another, she must not deliberately distort what she knows to be the law, for the circumstances may be such that the other lawyer will not have an opportunity to research the point, and will make a hasty decision or forgo certain rights in reliance on such a misstatement.[6]

It has been observed, however, that this rule does not require one lawyer to do the work of another.[7] Consider the following examples.

Example #4: A lawyer represents the seller of business assets. The lawyer representing the buyer fails to request the information necessary to submit a notice of bulk transfer to the New Jersey Division of Taxation. As a result, the buyer may become liable for any taxes the seller owes to the state of New Jersey. The seller's lawyer is not required to disclose to the other lawyer that it would be prudent to submit the notice.

Example #5: Consider the same facts as Example #4, except that the buyer's lawyer asks the seller's lawyer whether a notice of bulk transfer should be submitted to the Division of Taxation. What should the seller's lawyer do? At a minimum, she cannot misstate the law by stating that the form is unnecessary, but can remain silent or advise the buyer's lawyer to do her own research.

Example #6: Consider the same facts as Example #4, except that the buyer's lawyer states that a notice of bulk transfer is not required in this transaction. It is clear to the seller's lawyer that the buyer's lawyer misunderstands the law. What should the seller's lawyer do? The rule does not require one lawyer to do the work of another. The lawyer can remain silent, but must consider his or her integrity and reputation.

But Little White Lies are OK

The rule does not prevent a lawyer from making false statements of immaterial facts (*i.e.*, telling little white lies).[8] However, consider that a lawyer's word is his or her bond, and a lawyer's reputation for integrity is paramount. If a lawyer lies, he or she will soon earn a reputation as an untrustworthy person.

Example #7: A lawyer represents Party A to a contract negotiation. The lawyer for Party B wants to schedule a conference call on the following day for both parties and their lawyers to discuss some issues with the contract. The lawyer for Party A, who wants time to speak with his client, falsely states to the other lawyer that Party A is not available on the following day but will be available in two days. This is a false statement of an immaterial fact.

Bluffing, Puffing, Posturing and Opinions are OK

RPC 4.1 concerns facts, and not expressions of opinion, bluffing, puffing, posturing, etc. by a lawyer. Some misstatements are generally accepted and even expected in negotiations; for example, a lawyer's opinion on the purchase price of a business. Likewise, bluffing about whether a price will be acceptable to a client is expected. In this regard, Comment 2 to the American Bar Association (ABA) Model Rules states:

> This Rule refers to statements of fact. Whether a particular statement should be regarded as one of fact can depend on the circumstances. Under generally accepted conventions in negotiation, certain types of statements ordinarily are not taken as statements of material fact. Estimates of price or value placed on the subject of a transaction and a party's intentions as to an acceptable settlement of a claim are ordinarily in this category.

Consider the following examples.

Example #8: In order to increase the offer of an interested buyer, a lawyer states to the interested buyer that his client already has a firm offer of $1 million, when in fact he does not. The lawyer has knowingly made a false statement of fact, which is material and thus a violation of RPC 4.1(a)(1).

Example #9: In order to make a quick sale, a lawyer states to interested buyers that the business will sell quickly, and that they should make their highest and best offers. The lawyer has not made a statement of fact in violation of RPC 4.1(a)(1). Whether the business will sell quickly is a matter of opinion.

Example #10: A client tells her lawyer that she has a firm offer of $1 million, and asks the lawyer to convey that information to interested buyers. The lawyer is unaware that the client does not have such an offer. Without knowledge of its falsity, the lawyer has not violated RPC 4.1(a)(1), even though he has made a false statement of material fact.

Example #11: A lawyer is negotiating the terms of her client's purchase of a business. The buyer has advised his lawyer that he is willing to pay up to $5,000,000 for the business. The seller asks whether the buyer is willing to pay $4,500,000. Can the buyer's lawyer state that she is not sure her client will be willing to pay such a high price? Yes, this is considered acceptable bluffing or posturing during negotiations, and not a violation of RPC 4.1(a)(1).

Be aware that whether a statement is one of fact or opinion, puffing, posturing, etc., depends on the circumstances; for example, what is said, to whom and how. In this regard, the Restatement of the Law Governing Lawyers provides:

> Whether a misstatement should be so characterized depends on whether it is reasonably apparent that the person to whom the statement is addressed

would regard the statement as one of fact or based on the speaker's knowledge of facts reasonably implied by the statement or as merely an expression of the speaker's state of mind. Assessment depends on the circumstances in which the statement is made, including the past relationship of the negotiating persons, their apparent sophistication, the plausibility of the statement on its face, the phrasing of the statement, related communication between the persons involved, the known negotiating practices of the community in which both are negotiating, and similar circumstances. In general, a lawyer who is known to represent a person in a negotiation will be understood by nonclients to be making nonimpartial statements, in the same manner as would the lawyer's client. Subject to such an understanding, the lawyer is not privileged to make misrepresentations described in this Section.[9]

No Affirmative Duty to Disclose

Although RPC 4.1(a)(1) prohibits a lawyer from lying about material facts, generally it does not create an affirmative duty to disclose any facts to third persons. The ABA Comments state that "A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts."[10]

Example #12: A lawyer represents a manufacturer of watches, and is negotiating an agreement with a retailer. Both the manufacturer and the lawyer know that a competitor will soon introduce a superior watch at a reduced price. The competing watch is likely to undercut demand for the client's watch.[11] Under the arrangement, the retailer presumably will be required to purchase watches, spend money on advertising, etc. Neither the client nor the lawyer has made any statement about competing watches.

As noted, RPC 4.1(a)(1) does not create an affirmative duty to disclose any facts to third persons. Therefore, the lawyer does not have to disclose the competing watch to the opposing side, the retailer. The lawyer's duty is to the client and that duty is to maintain the confidentiality of the information.

Example #13: Consider the same facts as Example #12, with the following additional facts: "As negotiations are being wrapped up, the lawyer for the retailer's lawyer asks the manufacturer's lawyer whether there are any new models being introduced in the market that could hurt sales."[12]

The client did not make any statements to the retailer or its lawyer; therefore, there is no duty to disclose the material fact about the competing watches because there was no fraud by the client. RPC 4.1(a)(2) provides that "a lawyer shall not knowingly fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client."

However, if the client did make a statement about the lack of competition or the quality of the watches on the market, and knew that the competing watch would have an adverse effect on its watches, and thus on the retailer, this amounts to fraud, and requires the lawyer's disclosure of the material fact about the competing watches to the retailer.[13]

My Client Was So Bad, I Had to Tell Someone

A Lawyer's Duty to Disclose to Prevent Crime and Fraud

Under RPC 4.1(a)(2), a lawyer must disclose a material fact to a third party when disclosure is necessary to prevent a client from committing a crime or fraud.[14] Significantly, not only must a lawyer disclose material facts, but under RPC 4.1(b) a lawyer must make a disclosure even if he or she is required to disclose confidential information otherwise protected under RPC 1.6.[15]

In addition to RPC 4.1(a)(2), RPC 1.6(b)(1) *requires* a lawyer to: 1) disclose information 2) to the proper authorities 3) to prevent a client or another person from committing a criminal, illegal or fraudulent act 4) that the lawyer reasonably believes is likely 5) to result in death, substantial bodily harm or substantial injury to the financial interest or property of another.[16]

The purpose of RPC 1.6(b) is to require disclosure of information to *prevent* a client's criminal, illegal and fraudulent acts the lawyer reasonably believes is likely to result in death, substantial bodily harm or substantial injury to the financial interest or property of another. Three key terms in RPC 1.6(b) are "proper authorities," "substantial injury to the financial interest or property of another" and "reasonably believes."[17]

In transactional matters, the proper authorities may include the Securities and Exchange Commission, the New Jersey Department of Environmental Protection (NJDEP)and the New Jersey Division of Taxation, among others. However, when dealing with criminal, illegal and fraudulent acts that may result in death, substantial bodily harm or substantial financial or property damages, these disclosures could or should be made to the police, the county prosecutor or the Attorney General's Office. When in doubt, disclose the information to the county prosecutor.

There must be more than a remote possibility of potential harm to constitute a substantial injury to the financial interest or property of another.[18] Under RPC 1.0(m), the term "'substantial' when used in reference to degree or extent denotes a material matter of clear and weighty importance."[19]

Under RPC 1.6(e), the term "reasonable belief" means "the belief or conclu-

sion of a reasonable lawyer that is based upon information that has some foundation in fact and constitutes *prima facie* evidence of the matters referred to in subsections (b), (c), or (d)." Likewise, "reasonable belief" or "reasonably believes" means "the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable."[20] "Reasonable" or "reasonably" means "the conduct of a reasonably prudent and competent lawyer."[21] "Belief" or "believes" means a lawyer "actually supposed the fact in question to be true. A person's belief may be inferred from circumstances."[22]

The following are examples of mandatory disclosures under RPC 1.6(b).

Example #14: A client is being investigated by an administrative agency. The client and its lawyer advised the agency that the client did not compensate its landlord based on the revenues generated at the leased premises. The agency terminated its investigation of the client. Later, the lawyer discovers the client was, in fact, compensating an out-of-state affiliate of the landlord based on the revenues generated at the leased premises.

The lawyer reasonably believes the information was relevant to the agency's termination of its investigation, and that the client was perpetrating a fraud on the agency. When the client refused to disclose the information to the agency, the lawyer made the disclosure to the agency.[23]

Example #15: A lawyer is representing the seller of real estate with a leaking underground storage tank. For unknown reasons, the buyer's environmental expert did not locate the abandoned tank or evidence of a significant discharge of heating oil. The seller refuses to disclose the tank or the discharge to the buyer or the NJDEP. The lawyer reasonably believes the buyer is likely to incur substantial expenses in an environmental cleanup. The lawyer must disclose the discharge to the NJDEP to prevent his client from committing illegal and fraudulent acts (namely, failing to disclose the discharge to the NJDEP and failing to disclose the tank and the discharge to the buyer) that are likely to result in substantial injury to the financial interest or property of the buyer.

If a lawyer makes a disclosure to the proper authorities, under RPC 1.6(c) the lawyer *may* also disclose the information to the buyer to the extent the lawyer reasonably believes is necessary to protect the buyer from death, substantial bodily harm or substantial injury to a financial interest or property. However, even if a lawyer does not make a disclosure to the proper authorities under RPC 1.6(b), he or she is required to disclose a material fact to the buyer under RPC 4.1(a)(2) instead of under RPC 1.6(c).

In conclusion, when negotiating on behalf of a client, a lawyer must be cognizant of his or her obligations under the Rules of Professional Conduct and the relevant case law, and must be prepared to make difficult decisions about disclosure of material facts, and perhaps even confidential information, to third parties. ⚖

Endnotes

1. *Accord*, RPC 8.4(c) ("It is professional misconduct for a lawyer to engage in conduct involving dishonesty, fraud, deceit or misrepresentation."). *See also* Restatement (Third) of the Law Governing Lawyers, §98(1) (2000) ("A lawyer communicating on behalf of a client with a non-client may not knowingly make a false statement of material fact or law to the nonclient.").
2. *See Webster's Ninth New Collegiate Dictionary* 733 (1983), *cited in Longobardi v. Chubb Ins. Co. of New Jersey*, 234 N.J. Super. 2, 21-22 (App. Div. 1989).
3. *See* Geoffrey C. Hazard Jr. and W. William Hodes, *The Law of Lawyer*ing, §37.3; ABA Comment 2.
4. *Massachusetts Mut. Life Ins. Co. v. Manzo*, 234 N.J. Super. 266, 294 (App. Div. 1989).
5. *See, e.g., Malewich v. Zacharias*, 196 N.J. Super. 372, 377 (App. Div. 1984) (a lawyer may be liable for a misrepresentation made to the other lawyer who relies on the misrepresentation).
6. Hazard and Hodes, §37.3.
7. Hazard and Hodes, §37.3.
8. *See, e.g.*, Hazard and Hodes, §37.3 ("a lawyer is not prohibited from making deliberate misstatements to a third party during representation of a client, so long as only immaterial falsehoods or misrepresentations are at issue.") (emphasis in original).
9. Restatement, §98, Comment c.
10. ABA Model Rule 4.1, Comment 1. *Accord*, Restatement, §98, comment e ("In general, a lawyer has no legal duty to make an affirmative disclosure of fact or law when dealing with a nonclient.").
11. *See* Hazard and Hodes, §37.3, Illustration 37-1, ¶1.
12. *See* Hazard and Hodes, §37.3, Illustration 37-1, ¶2.
13. *See* RPC 4.1(a)(2).
14. *Accord*, RPC 1.2(d) ("A lawyer shall not counsel or assist a client in conduct that the lawyer knows is illegal, criminal or fraudulent ..."); RPC 1.6(b)(1), (c) and (d)(1). *See also* Restatement, §98(3) ("A lawyer communicating on behalf of a client with a nonclient may not fail to make a disclosure of information required by law."). Note that New Jersey is different from other jurisdictions. Whereas New Jersey requires disclosure, ABA Model Rule 4.1(b), for example, merely permits disclosure.

15. *Accord*, RPC 1.6(b)(1), (c) and (d)(1).
16. Again, New Jersey is different from other jurisdictions. RPC 1.6(b)(1) requires disclosure, whereas ABA Model Rule 1.6(b)(1) merely permits disclosure. *See A v. B.*, 158 N.J. 51, 59 (1999); Advisory Comm. Op. 677 (Oct. 10, 1994). *Also*, New Jersey includes the term "illegal" in RPC 1.6(b) whereas the ABA Model Rule does not. *See* Kevin H. Michels, *New Jersey Attorney Ethics* (Gann), § 15:3-3(a).
17. This article concerns disclosures to prevent a client's bad acts. A lawyer should review RPC 1.6(d) for disclosures he or she reasonably believes necessary to rectify the consequences of a client's bad acts when the client has used the lawyer's services to commit such acts. A lawyer should also review RPC 1.2(d) and RPC 1.16 for circumstances when a lawyer must withdraw as counsel to a client.
18. *See A v. B*, 158 N.J. 51.
19. *See also* Michels, § 15:3-3(d).
20. RPC 1.0(j).
21. RPC 1.0(i).
22. RPC 1.0(a).
23. *See* Advisory Comm. Op. 677.

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