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You Didn't Write It, But You Will Be Fixing It: Evaluating the Allocation Provisions in an LLC Operating Agreement

By Gwendolyn Griffith, Tonkon Torp LLP

All of us have been asked to evaluate (and perhaps repair) a limited liability company (LLC) operating agreement[1] someone else drafted, perhaps long ago. This article describes a process for evaluating the economic aspects of such an agreement with a focus on the allocation provisions. Because allocations are but one of the three gears driving the economics of any operating agreement, I also discuss how the other two gears—contributions and distributions—work with the allocation gear to create a workable allocation engine.

Lucky business lawyers have a tax specialist in their firm to take on this task, but not everyone has a tax lawyer right down the hall. In any event, business lawyers benefit from a basic understanding of what tax lawyers seek to accomplish in their review of the economics of operating agreements.

The material in this article is necessarily general and does not address every aspect of review. Along the way, I point out common problems and the areas in which a business lawyer should seek specialized tax advice. I refer to the person who reviews the operating agreement as the "Evaluator," and will assume the following:

- The LLC has more than one member.[2]
- The LLC has not made an election to be taxed as a corporation.
- All owners are members, i.e., there is no non-member with economic rights.[3]
- The members are open to revisions as needed to reflect their expected deal.
- The Evaluator is not expected to implement some new economic arrangement.

Finally, it is much too easy to criticize a previous lawyer's work. Do embark upon an evaluation with an open mind, and assume that the drafter had good reasons for the choices made. One never knows what the client discussed with the drafter, or what they all understood of that discussion. Times have changed, deals have changed, and the way tax lawyers approach allocations today is much different from how they approached them even ten years ago.

The evaluation process

The Evaluator has three tasks to accomplish:

1. Understand the intended economic deal among the members.
2. Determine if the existing language implements that deal.
3. Implement changes as needed.

To accomplish these tasks, the Evaluator must understand his or her mission. First, who is the client (an issue beyond the scope of this article)? Is the mission simply to make sure that the operating agreement generates the right economic results—no matter how clunky—or to fill gaps, simplify, or modernize it? How important is certainty in the situation? The most challenging of missions is probably the most common: change as little as possible.

Task 1: Understand the intended economic deal

The operating agreement is intended to capture the members' desired economic consequences. The Evaluator asks, "Does it?" To answer that question, the Evaluator must understand the intended deal.

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Gwen Griffith is the practice group leader for the Tax and Employee Benefits Practice Group at Tonkon Torp LLP. She extends her thanks to Mark LeRoux and Adam Adkin for their input into this article; all errors or misstatements remain her own.This is not tax advice, and because each situation is different, lawyers should seek specialized tax counsel regarding any particular situation.

Most clients care only about contributions and distributions. They want to know what they must put up and what they will get out of the LLC. The Evaluator must be a little more technical, and understand:

- Which members contributed what, in terms of cash, property, and services, and are all or some members obligated to make any contributions in in the future?
- How and when will the cash and property of the venture be shared among the members?

Some owners remember perfectly, and even agree upon the economics that they intended when the operating agreement was drafted. In the simplest of "plain vanilla" deals, there really isn't that much to remember. These deals are usually "share and share alike" or "all contributions back first, then to members based on percentages."[4] Yet, as economic complications multiply, owners' memories become less reliable. The Evaluator must then turn to other sources.

Because an enforceable obligation to make contributions must be in writing in Oregon, (ORS 63.180(1)), it is fairly easy to determine the contribution side of this equation. If memories are unclear about intended distributions, contemporaneous notes, offering documents (if any), balance sheets, income statements, and tax returns of the entity offer valuable clues. Business lawyers are fully familiar with the treasure troves of information offered by balance sheets and income statements, but what tax returns can reveal may be less obvious.

Any tax professional will tell you that a tax return provides a host of information about the taxpayer—if you just know where to look. The annual Form 1065 as filed by the entity shows what has actually occurred, which may be the best evidence of what the parties intended. In ambiguous situations, both business and tax lawyers can benefit greatly from a conversation with the entity's tax preparer.

The tax return contains a balance sheet that, for example, separately states member-related debt and third-party debt and can be compared to management-produced balance sheets. The Schedule K-1 for each member provides some important clues to the economic deal, including each member's contributions made during the year, capital account (discussed in more detail below), profit and loss percentages, allocations of specific types of income, distributions received during the year, guaranteed payments, and sharing of debt and changes in that debt.

In addition, most tax returns also include "statements" that offer detail for these items or other items on the tax return. For example, now that all entities taxed as partnerships must report capital accounts on the tax returns using the tax basis method,[5] the statements will likely reveal the entity's use of another method to maintain capital accounts for owners.

Once the Evaluator believes he or she understands the intended economics, providing a summary and obtaining confirmations from the client is recommended.

Task 2: Does the existing language implement the deal?

Once the desired economic consequences are established, the next step is to compare those with the language of the operating agreement.

Contributions

The operating agreement under review likely included a schedule[6] that recorded the original members, their contributions, and what they received for that contribution (units, percentage interests, etc.). A common problem in evaluation is that this schedule is referred to in the operating agreement and is included as a schedule, but is blank or incomplete. It is likely that this schedule has not been updated for subsequent contributions or new contribution obligations. The evaluation process is the right time to update this schedule, retaining the original contributions and updating them to the agreed-upon contributions as of a current date. Any contributions currently required but not yet made should be reflected on this schedule. For LLCs maintaining capital accounts, it is helpful to include agreed-upon capital accounts as of that date, both for tax purposes and any other method required by the operating agreement.

Distributions

At a minimum, LLC members expect their lawyers to get the distributions right. As a preliminary matter, when clients say "distributions," they mean "good stuff in my pocket from the LLC." Therefore, taking a wide lens on this issue is advisable. The Evaluator will consider the following provisions to determine if they achieve the intended economic consequences:

- Payments to owners for services or capital (guaranteed payments)
- Tax distributions
- Operating distributions
- Liquidating distributions, i.e., those made when the LLC is in dissolution
- Draws and loans to owners

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Not every operating agreement will have each of these attributes, but it should have at least operating and liquidating distributions.

Tax distributions. Tax distributions are made to assist members in meeting quarterly estimated tax payments on income passed through to them from the LLC. Common missteps in tax distributions include a failure to clarify whether tax distributions are an advance on operating distributions, an unworkable level of complexity in computing tax distributions, untimely distributions, and computing tax distributions only on the current year's profits rather than over the life of the LLC. This is an area where the Evaluator can often recommend clarification and simplification.

Operating distributions. Operating distributions (also known as interim distributions) are distributions made from operating cash flow during the life of the LLC. The operating agreement under review should answer these fundamental questions: which members receive distributions, and when are these distributions to be made? Subsidiary issues include the authority to declare operating distributions, and the limitations on those distributions. Are such distributions actually draws (loans) that are subject to clawback or offset, and if so, under what conditions? Or are clawbacks part of the core deal, as is critical with most carried interests? When a waterfall distribution scheme is intended (e.g., "$X to Class A Unitholders, then $Y to Class B Unitholders, and then in proportion to Unit Ownership"), the measure of the amounts distributable to each class of members must be crystal clear. The Evaluator will have the advantage of access to the LLC's history of distributions to compare against the language of the operating agreement, but is well advised, in complex deals, to model distributions in light of possible future circumstances. A lawyer uncomfortable with such modeling should collaborate with a tax professional.

Liquidating distributions. Liquidating distributions are the distributions made to members when the LLC is in a state of dissolution. This brings us to the heart of the allocation issue. When the LLC dissolves and distributes its net assets to members, who gets what? The liquidation section almost universally begins with payments to creditors, followed by payment of amounts owed to members and former members. (See ORS 63.625(1)-(3).) Finally, the LLC must distribute the remaining amounts to members, either by the positive balances in members' capital accounts or a formula, which can be as simple as "in proportion to units" or as complex as any investment banker can conjure up.

In some operating agreements, the liquidation-to-members provision simply refers back to the operating distribution language. This is perfectly fine, if operating and liquidating distributions implement the same economic plan.

Allocations

Except in tax-oriented deals, discussed below, most clients don't think much about allocations. To them, the allocation sections of an operating agreement are a messy lot of technical gibberish best left to lawyers.

What exactly is an allocation? It is the assignment of a portion of an LLC's profit or loss (or items thereof) to a particular member in accordance with the operating agreement for tax and economic purposes. Tax allocations appear on the member's Schedule K-1 from the LLC and on the member's tax return. Many LLCs also track book allocations using other methods, such as financial accounting capital accounts, or capital accounts using the regulations under IRC § 704(b).[7]

With this in mind, the Evaluator should examine the four essential components of establishing viable allocations:

- Defining profit and loss
- A clear method for sharing profits and losses among members
- Keeping track of allocations
- Substantial economic effect

Defining profit and loss. The operating agreement must include a clear and complete definition of the profits and losses that will be allocated. Fortunately, one does not have to start from scratch. Common definitions include profit and loss as measured for federal income-tax purposes, for the company's financial accounting purposes, or as prescribed in the regulations under § 704(b). Some operating agreements adopt more arcane measures, which is often a function of a particular regulatory environment in which the LLC operates. The Evaluator must analyze whether the definition is complete, internally consistent, and appropriate for the LLC's circumstances.

A clear method for sharing profits and losses among members. The operating agreement must include a clear and workable method for sharing profits and losses (and items thereof) among members. Allocation formulas can be as simple as fixed percentages or proportionality to units owned, or as complex as a waterfall allocation based on internal rates of return. A sharing formula can, and often does, change over time.

There is no limit on the complexity of allocation formulas. The more complex the formula, the more important it is to model the results of the allocations to ensure consistency with desired economic results, in both expected and unexpected operational conditions. The Evaluator of an existing operating agreement has a somewhat easier task than the original drafter. The Evaluator can review the tax returns and balance sheets to determine whether the allocations created the desired economic results in the past. But, like the drafter of any operating agreement, the Evaluator will likely want to model how the allocations affect liquidating distributions under various future scenarios. Again, collaborating with tax professionals can be helpful.

Keeping track of allocations. Because many years may elapse between organization and dissolution of an LLC, an operating agreement

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should in most cases include a way of keeping track of allocations over time. The most common approach is the establishment of capital accounts. When capital accounts are used, the capital account of each member is credited with contributions, increased by allocations of profits, and decreased by allocations of losses and by distributions. Other variations on the maintenance of capital accounts can be included.

Substantial economic effect. Allocations of profit and loss don't live in isolation within the members' deal; taxing authorities are also interested in them. The IRS wants to ensure that the correct members pay taxes on the LLC's income and that the correct members are reporting the LLC's losses. If the IRS disagrees with an LLC's allocations, it can reallocate profits and losses among the members of the LLC to reflect a different allocation scheme. This doesn't sound so bad, until one considers that tax returns were filed and taxes were paid on the basis of the original allocations, and undoing all that is expensive and time-consuming. That said, reallocation challenges are relatively rare.

The interest of the IRS in allocations arose because of the tax-shelter industry that peaked in the early 1980s.

The interest of the IRS in allocations arose because of the tax-shelter industry that peaked in the early 1980s. These deals rarely if ever achieved economic viability independent of tax benefits and the IRS viewed them as nothing more than the purchase of tax benefits (losses and credits). The IRS fought these tax shelters using § 704(b), which has long required that allocations have "substantial economic effect." In 1985, it promulgated final regulations containing specific requirements for substantial economic effect (the "§ 704(b) Regulations"). Although just a year later the 1986 Tax Reform Act eliminated most tax shelters by creating the passive loss rules, the § 704(b) Regulations lived on and indeed inform most operating agreements today.

The fundamental principle of the § 704(b) Regulations is that allocations must be consistent with the economic deal of the members. (Treas. Reg. § 1.704-1(b)(2)(a)(i).) If a member is allocated a loss or deduction, that allocation must reduce the dollar amount the member is entitled to receive. Likewise, an allocation of profit must increase the amount the member is entitled to receive.

The § 704(b) regulations offer two pathways for achieving substantial economic effect: safe harbor and the partners' interests in the partnership.

Safe harbor requires that capital accounts be maintained in accordance with a robust set of rules, liquidation proceeds be distributed in accordance with the positive balances in members' capital accounts, and members with deficit capital accounts at liquidation be required to make those up, or that the operating agreement contain specific provisions relating to allocations income that will cause negative capital accounts to be restored to positive territory. (Treas. Reg. § 1.704-1(b)(2)(ii)(b); (d).) The effect of the allocations must also be "substantial,"a topic beyond the scope of this article. If an operating agreement meets the requirements of this safe harbor, its allocations will be immune from reallocation. (Treas. Reg. § 1.704-1(b)(3).) If the operating agreement under review takes this approach (which many do), the Evaluator has a difficult job. Given the wide variety of language that can be used to express the safe harbor requirements, it can be difficult to determine if an operating agreement conforms to the safe harbor requirements and doesn't include anything that might undermine qualification.

The Evaluator must also address the allocation formula in an operating agreement that adopts the safe harbor approach. These formulas can be complex and testing them for effectiveness is part of the Evaluator's job.

Safe harbor certainty comes at a steep price: complexity, and the requirement that liquidating distributions be made in accordance with capital accounts. (Treas. Reg. § 1.704-1(b)(3).) Far too frequently, allocation errors made over years of operation result in liquidating distribution quagmires that cannot be fixed by going back in time. Members are then quite disappointed with their lawyers.

As a result, many modern operating agreements choose the second pathway to substantial economic effect offered by the § 704(b) regulations: allocations will be respected if they are consistent with the "partners' interests in the partnership"(PIP). (Treas. Reg. § 1.704-1(b)(3)(i).)

Under the § 704(b) Regulations, a PIP is to be determined by reference to the underlying economic arrangement of the partners relating to the particular allocation under consideration. Analysis of that arrangement takes into account all of the facts and circumstances of the situation, and specifically considers contributions, interests in profits and losses and in cash flow and operating distributions, and liquidation rights. (Treas. Reg. § 1.704-1(b)(3)(ii).)

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The simplest of operating agreements can rely on the PIP approach to protect the allocations from IRS suspicions without too much complexity. When the partners' relative shares of contributions, interim distributions, liquidating distributions, and profits and losses are all the same, it is clear that the allocations follow the members' interest in the LLC. Plain vanilla operating agreements don't need to fit into the safe harbor—the IRS has no reason to challenge those allocations because they do not vary from the agreed-upon economics of the deal.

Perhaps surprisingly, given lawyers' aversion to squishy tests, even complex deals use the PIP approach. They do so to ensure that final distributions implement the members' agreed-upon deal. Many of these operating agreements adopt the target allocation approach, in which the formula for allocations is driven by members' rights to liquidating distributions. At the end of each year, the LLC determines the amount each member would have received if the LLC had sold its assets at book value and then liquidated at the end of that year. Each member is allocated profits and losses and items of income and deduction so that member's capital account equals the amount the member would receive in liquidation. The devil is in the computational details. Who is responsible for making this computation and the sources of information that person may rely upon is often murky.

The Evaluator faced with this type of allocation provision has a fairly easy job—at least at first. The allocation provision is usually deceptively simple. Implementation is complex.

A member's beginning capital account is increased by contributions and decreased by distributions during the year. The capital, as partially adjusted, is compared to the hypothetical liquidating distribution to the member. Profits, losses, and items and income and deduction are then specially allocated to make the member's year-end capital account equal the member's hypothetical liquidating distribution. The Evaluator will compare the language of the operating agreement with what actually happened, as revealed by the tax returns and ancillary documents, to make sure that the deal has been properly expressed through allocations. The tax preparer should be consulted in this process.

When the underlying business doesn't involve real estate investments, doesn't rely heavily on debt, and doesn't involve state or federal tax credits, this may be enough.

But if any of those or certain other complicating factors exist, many drafters take what I call the "PIP-Plus" approach. This approach relies on the PIP pathway to substantial economic effect, but adds many of the bells and whistles of the § 704(b) regulations. These could include, for example, requiring an owner whose capital account becomes negative to be allocated profits sufficient to restore that capital account to positive territory. This is the "qualified income offset" familiar from the safe harbor regulations. See Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3).

If debt is a significant feature of the business plan, PIP-Plus might import the minimum gain chargebacks rules into the operating agreement.

Because allocations attributable to nonrecourse debt can never have economic effect (only the lender will suffer, not the members), the § 704(b) regulations include special rules for these allocations. See generally Treas. Reg. § 1.704-2.

This creates a hybrid allocation section within an operating agreement that has characteristics of both the safe harbor approach and the pure PIP approach. This can quickly become complex and is an area where advanced tax skill is recommended to properly choose which provisions to incorporate.

Clients typically leave the allocation provisions to their lawyers and accountants. However, the Evaluator faced with PIP or PIP-Plus allocation structures should make sure that the clients are aware that there is no certainty that the IRS will respect the allocations.

Common problems

Finally, along the way, the Evaluator may see some common problems with the economic sections of an operating agreement. Here are just a few:

- Disjointed operating and liquidating distribution sections, in which required tax or operating distributions are not coordinated well with liquidating distributions.
- The operating agreement defines and allocates profits and losses among capital accounts, completely and elegantly, yet these allocations serve no purpose, i.e., they have no effect on the LLC's economics (or anything else). This is usually encountered in PIP and PIP-Plus agreements, discussed above.
- The economics are so weird that the entire transaction seems like "something else," perhaps a disguised sale or a tax shelter.

In such cases, trust your instincts that something is *just not right*, and seek help.

Task 3: Implement necessary changes

If you are still reading this article, you have probably already concluded that "fixing" allocation provisions in an operating agreement is easier said than done. As discussed above, the Evaluator must approach Task 3 with a clear eye on his or her specific mission to determine which changes, if any, are necessary. In addition, revisions to the allocation provisions (which we now understand to include the contribution and distribution sections as well) must be coordinated with other revisions of the operating agreement that may have some connection with the revisions of the allocation provisions, such as the buy-out provisions.

Of course, every lawyer has a preferred approach to revisions to ensure they are complete and internally consistent. In revising the economic aspects of an agreement, I find it best to proceed in this order:

1) Contribution sections
2) Distribution sections: tax, operating, and liquidating
3) Allocation sections

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When revisions are complete, these three gears should turn smoothly. Of course, an Evaluator will want to test those gears to make sure they do in fact work as intended.

In some cases, the Evaluator will conclude that material errors were made in translation of the members' intentions to the operating agreement, or from the operating agreement to the LLC and members' tax returns, or both. In that case, the clients have tough choices to make.

One approach is to file amended returns for years in which errors were made. This is probably the most technically correct approach, but can be expensive and time-consuming when many years may be involved.

The other approach is to make appropriate adjustments in the year of discovery and then move forward with everyone on the same page. This is a riskier approach, but may be the more practical of the two.

The hardest job for the Evaluator in reviewing an operating agreement is seeing what is missing.

A few final thoughts

First, the hardest job for the Evaluator in reviewing an operating agreement is seeing what is missing. The three-step process described above should trigger inquiry into many of those items. It is helpful to step back and ask, "What's not here that should be?"

Second, it is always cheaper to build new than to remodel. In many cases, once a client understands the tasks that the lawyer has to undertake to evaluate an existing operating agreement, it may be easier just to restate the entire operating agreement rather than revise it. This will not necessarily address errors that have crept into the mix in previous years, so opening capital accounts may be murky, which in turn could affect the fundamental economics of the deal.

Third, and most important, ask for help when you need it. No one does this kind of work alone and we are all in this endeavor together. ◆

Endnotes

1. Unless specifically stated, references to an LLC include a limited liability partnership, limited partnership, and general partnership, assuming no election to be taxed as a corporation. Similarly, references to an "operating agreement" include the governing agreement of these entities.
2. Unless it has otherwise elected, an LLC with a single member is a disregarded entity and its operations are reflected its single owner's tax return. Therefore it does not have (or need) allocations. I too often see single-member LLC operating agreements with complex safe harbor allocation provisions. The rationale for including them is that the original member might admit another member. I recommend that these allocation provisions not be included. If another member is admitted, most of the operating agreement will have to be amended, and the allocations will be addressed at that time.
3. In many operating agreements, allocations and distributions are made among "members" of the LLC. While appropriate at the outset of the LLC, not every member will retain that status. Some members will become non-members with only economic rights. Therefore it is important to allocate profits and losses among those who have economic interests in the LLC, not among "members." Another solution to this problem is to include a section that defines the term "member," solely for the economic purposes of the LLC, to mean any person having an economic interest in the LLC.
4. See ORS 63.195(1), which provides that if neither the articles of organization nor the operating agreement specify the manner in which interim (operating) distributions are to be made, they will be made in the same proportion as the members share profits. ORS 63.625(3) provides that in such circumstances, liquidating distributions will be made first to members to return to them their unreturned contributions, and thereafter in accordance with the manner in which profits are allocated.
5. See IRS Notice 2020-43, 2020-27 IRB, for a discussion of this rule and the methods for computing a tax basis capital account.
6. Modern best practice is to include a schedule to the operating agreement rather than including this information within the body of the operating agreement, as this facilitates ease of negotiation of, and changes to, this information. The schedule should include the names of members, their respective contributions, and what they received in exchange, e.g., units or a percentages share.
7. All section (§) references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, and the Regulations thereunder.

The No Third-Party Beneficiaries Clause

By Stephanie Davidson, FP Transitions LLC

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This article is part of a series on miscellaneous contract provisions in common business, commercial, and real-estate agreements. When disputes arise, these overlooked provisions can determine the fate of a transaction. If not closely examined in the context of every agreement, they can provide grounds for litigation or threats of litigation.

I have often encountered a situation in my practice where a No Third-Party Beneficiaries clause is inadvertently included in a contract's boilerplate terms, but there are intended third-party beneficiaries to the contract. The drafter has created a contract with conflicting terms that breed confusion, disagreement, and potential litigation.

Here is one example of this often-used clause, which is typically included in the miscellaneous terms at the end of a contract:

> ***No Third-Party Beneficiaries.*** *The parties do not intend to confer any right or remedy on any third party.*

Generally speaking, a third-party beneficiary is a person who is not a party to a contract, but who stands to gain from the contract's performance, or who would be injured by its breach. In most instances, a person who is not a party to a contract cannot enforce or defend it. This is the requirement of privity of contract for a claim based on contractual rights or obligations. Over time, courts have recognized exceptions to this general rule and have allowed certain third parties to enforce contracts to which they are not parties. They are so-called "third-party beneficiaries." The contours of this term of art are beyond the scope of this article. For a succinct summary of this legal concept, and some helpful examples, I recommend Paula M. Bagger's article titled "Third-Party Contract Beneficiaries: What Did the Parties Intend?", which was published by the American Bar Association. Available at https://www.americanbar.org/groups/litigation/committees/commercial-business/boilerplate-contracts/third-party-contract-beneficiaries (Jan. 22, 2020). As Ms. Bagger suggests in her article, this is an arcane and confusing body of caselaw. Review of binding precedent in the applicable jurisdiction would be required to add predictability to any situation where a third-party beneficiary issue is implicated.

When drafting a contract, the best practice is to consider who the third-party beneficiaries might be, and ensure that these parties are named and carved out of any No Third-Party Beneficiaries clause.

For example, if a contract includes an indemnity right that extends to the shareholders, directors, members, managers, partners, officers, and authorized representatives of a party, the drafter should either omit the No Third-Party Beneficiaries clause entirely, or carve out either the indemnity clause or the indemnified parties from the No Third-Party Beneficiaries clause. With respect to the second approach, this is how I would modify the No Third-Party Beneficiaries clause:

> ***Third Party Beneficiaries.*** *Except as provided in Section __, the parties do not intend to confer any right or remedy on any third party.*

> ***Third Party Beneficiaries.*** *Except for the Indemnified Parties, the parties do not intend to confer any right or remedy on any third party.*

In the first example, the drafter should provide a specific cross-reference to the indemnification clause. In the second example, the drafter should define the term "Indemnified Party" in the indemnification clause. In both examples, the drafter should aim to carefully capture every exception to the statement that there are no third-party beneficiaries.

But beware: there is risk for even careful drafters who attempt to carve out specific exceptions to a No Third-Party Beneficiaries clause. While preparing to write this article, I discovered Glenn D. West's article titled "No-Third-Party-Beneficiary Clauses and the Ever-Evolving Contractual Arms Race," which was published by Weil, Gotshal & Manges LLP. Available at https://privateequity.weil.com/glenn-west-musings/no-third-party-beneficiary-clauses-and-the-ever-evolving-contractual-arms-race/ (Sept. 9, 2020).

Mr. West's article is worth reading for its summary of a recent case from the Delaware Court of Chancery that involved the interpretation of an asset purchase agreement with conflicting indemnity and third-party beneficiary terms. It is also worth reading for its entertaining use of quirky naval history trivia to explain the point of this article: Unexamined boilerplate terms can sometimes cause unintended chaos. ◆

That's Not True! Considering Whether to Respond to a Negative Social Media Post

By David J. Elkanich and Amber Bevacqua-Lynott, Buchalter

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You have enjoyed full-star ratings on all of the legal ranking websites for two years. Then suddenly you receive word that your former client, Litigious, who had failed to provide you with damaging information that eventually came out in deposition to his detriment has taken to bashing you on any online platform that will allow him access. Litigious has said that you are incompetent, and missed a deadline that caused his case to be dismissed. But you didn't and you believe that Litigious's comments are not only bad for business but also defamatory.

What should you do? Are you ethically prohibited from responding to the post with confidential information?

This question was answered, at least in part, by the Oregon Supreme Court's recent decision in ***In re Conry***, 368 Or. 349, 491 P.3d 42 (2021). As Oregon attorneys, we have often queried about how much we can say online—particularly in response to former clients making negative comments about our services or the outcome of a particular case. The Oregon Supreme Court provided some surprisingly positive guidance as to what and how much can be disclosed by lawyers to defend ourselves and our reputations.

The ethical framework

The import of the court's decision in *Conry* derives at least in part from the fact that the legal profession is often slow to react to changes in technology, and the rules that govern attorneys are always playing catch-up. (A good example of this is that the ABA first mandated that law schools must teach ethics to get the association's approval in response to Watergate. (See "1965-1974: Watergate and the rise of legal ethics" https://www.abajournal.com/magazine/article/1965).While Oregon lawyers may attempt to embrace new marketing opportunities afforded by the internet and social media, time and time again lawyers have been limited in their online activities by outdated advertising and confidentiality rules that have not anticipated the instant impact (positive and negative) or the widespread access that these technologies afford.

Lawyers who engage in online activities must consider at least two of the Oregon Rules of Professional Conduct. First, RPC 7.1 prohibits false or misleading information about a lawyer or the lawyer's services, even in advertising. The policy behind the rule that requires accurate information that is not misleading is fairly obvious.

Second, RPC 1.6(a) prohibits a lawyer from disclosing information relating to the representation of a client, which in Oregon is defined to include information protected by the attorney-client privilege under applicable law, and other information gained in a current or former professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or likely to be detrimental to the client. See RPC 1.0(f). The legal profession has a long tradition of protecting confidential information, which enables clients to provide full and truthful information, and which in turn facilitates competent legal advice.

And even though the concept of privacy changed dramatically in the age of Facebook, Instagram, and YouTube, regulators have continued to give RPC 1.6 extreme deference, cautioning lawyers from "speaking out" against negative reviews and online gripes (actual or invented). See, e.g., Los Angeles County Bar Association 525 (2012); NYSBA Opinion 1032 (2014); ABA Formal Opinion 496 (2021). Similarly, in "The Ethics of Online Blogging, Posting and Chatting By Lawyers," (OSB Bar Bulletin, July 2018), the Oregon State Bar's General Counsel cautioned lawyers to remember that in blogs, social media, and other forms of internet advertising, publicly available information does not necessarily equate to publishable information under the restrictions of RPC 1.6(a).

The advice has long been to say nothing when confronted with negative social media; or, at most, to use a generic post such as the following: "The post is inaccurate. I represented this client zealously and effectively. My ethical duty to protect this client's confidences prevents me from responding in more detail. Please see my website for accurate information about my practice."

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Put another way, the lawyer has traditionally been told to take the "high road," and follow the age-old advice that "if you can't say something nice about someone—say nothing." Although this is still good advice, it may be more conservative than it need be, given the Supreme Court's recent holding.

In re Conry

In *Conry,* a client posted a negative review of an immigration lawyer on multiple websites. The lawyer viewed those reviews as defamatory. In particular, the client indicated that he "was not deportable with the charges that he had." The lawyer responded to that assertion by contending that the client's criminal charges had allowed the client to be deported, under the law as it existed when the client had hired respondent. *Conry*, 368 Or. at 369. The lawyer also provided the client's name in a response to one of the three posts.

Recognizing the importance of the case, the court began by discussing online reviews and client confidentiality in general. On one hand, the court observed:

> "[I]t appears that negative online reviews may have a dramatic impact on an attorney's income. … One law review article from 2015 contained substantial discussion of the effects of online reviews on businesses generally, and—to the extent the data was available at the time—on attorneys specifically. … A 2014 study, for example, had concluded that '[e]ighty-three percent of respondents indicated that their review of online feedback was their first step to finding an attorney.' … In the context of online reviews of restaurants, a 2011 study concluded that a drop of one star in ratings could affect revenue between five and nine percent. …" *Conry*, 368 Or. at 360 (citations omitted).

On the other hand, the court noted that "[t]he attorney's ability to harm the client is amplified when an attorney can functionally publicize a client's secrets to the entire online world at the click of a button." *Id*. at 361.

The court reviewed the lawyer's disclosures and found that they were "information relating to the representation of a client" and therefore protected by RPC 1.6(a). *Id.* at 365.

The court then explored whether RPC 1.6(b)(4)—the so-called self-defense exception—would apply, and thus permit the lawyer to provide the responses he did. That provision provides, in relevant part, that a "lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client …".

The court first sidestepped whether the client's reviews created a controversy between lawyer and client for purposes of RPC 1.6. Although the court concluded that it need not resolve the question, it still assumed a controversy existed and turned to the question of whether the lawyer reasonably believed it necessary to reveal the information he did.

The court broke down the revealed information into two categories: the client's criminal convictions and the client's identity. Significantly, it found that the lawyer could disclose the first category of information under the circumstances. The court said the lawyer could have reasonably believed that disclosure of the client's criminal convictions was necessary to rebut the client's contention that the lawyer was unaware of the applicable immigration law. It was therefore reasonable to share the convictions to demonstrate that the lawyer had provided the correct guidance under existing law. Thus, even though the information was confidential and protected by RPC 1.6(a), the information was revealed "at least arguably to explain to the audience the grounds the government had asserted for deportation—conviction of a crime involving moral turpitude—and whether client's crimes constituted such a crime." *Id*. at 370.

The client's identity, however, was determined not to be an objectively reasonable disclosure, particularly where it was disclosed in conjunction with the information about the client's convictions. When this information was disclosed together, it enabled "anyone who searched for client's name in an internet search engine, for any reason whatsoever, [to] uncover the details of client's criminal convictions." *Id*. at 370.

Accordingly, the court clarified that a lawyer may no longer have to simply turn the other cheek. When she or he reasonably believes it necessary to establish a claim or defense in a controversy with a client, a lawyer may respond to negative online reviews by disputing the allegations.

Conclusion

It is fair to say that just because a lawyer can respond, it does not mean he or she must or should do so. A lawyer should first take a deep breath after receiving a negative social media review and determine if there is anything to learn from the post (e.g., could the lawyer have treated the client better?). But if a post could be considered defamatory, a lawyer may now consider whether posting additional details would be appropriate in light of the *Conry* decision. ◆

Business Law Section News

Introducing the New Executive Committee Members

Joe Cerne
Lane Powell

Joe has served as a member of the New Business Lawyers Subcommittee since 2019, and is now its Chair. Joe's practice primarily consists of corporate and transactional matters, including mergers and acquisitions, entity formation, corporate governance, and contract negotiations. Outside of the office, Joe enjoys playing basketball and golf, and tries to stay active year-round by exploring the outdoors with friends and family.

Krista Evans
Evans + Evans Law

Krista is a transactional attorney focusing on business and real estate law. Her experience includes entity formations, contract drafting and review, outside corporate counsel services, commercial finance, and commercial real estate purchases and sales. Krista is particularly specialized in mergers and acquisitions.

Kaci Hohmann
Emerge Law Group

Kaci focuses her practice on mergers and acquisitions, corporate finance and securities, corporate governance, and general business matters. She is licensed in Oregon and New Jersey and serves on the executive committee of the Oregon State Bar Cannabis and Psychedelics Law Section. In her free time, Kaci enjoys camping, hiking, and reading.

Melissa B. Jaffe
Law Offices of Melissa B. Jaffe

Melissa is a licensed attorney in Washington, Oregon, and California. She practices transactional law, focusing on intellectual property. When she is not working, you can find her exploring outside with her child and two St. Bernards, or teaching a yoga or meditation class.

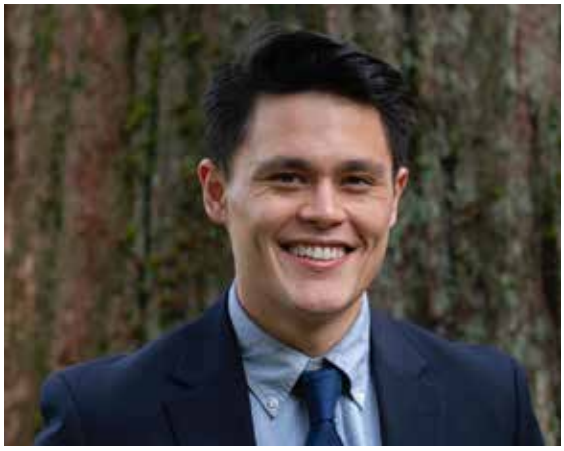
Benjamin Pirie
Miller Nash

Ben counsels cannabis businesses on a wide range of corporate and regulatory needs. He advises on mergers and acquisitions, negotiating complex contracts and corporate governance, as well as regulatory compliance in the emerging cannabis and hemp industries.

Law Student Summer Stipend Awarded

In lieu of its annual scholarship program, the Business Law Section donated funds to the Oregon State Bar's Diversity & Inclusion Department to help provide two $3,360 stipends for students wo will be working in the field of business law in summer of 2022.

Austin Willhoft is the recipient of the Section's first stipend.



Austin Willhoft is a first-year law student of the JD/MBA program at Willamette University. After working in Taiwan as a journalist and video producer, Austin pivoted to law to pursue leadership and management positions in US-based companies operating abroad.

He volunteered as the 1L representative for the university's Asian Pacific American Law Students Association.

Austin is eager to use his JD/MBA program skills to find common-ground solutions for USA companies expand to international markets. ◆

The Oregon State Bar (OSB) Diversity & Inclusion Department, with the assistance of the Advisory Committee on Diversity and Inclusion, administers summer employment stipend programs for law school students who will help achieve the Bar's diversity mission. Two Public Fellowship Summer Stipend awards are reserved for each of the three Oregon law schools. Any remaining astipends are open to all continuing Oregon law students. The 2022 Handbook has detailed information regarding both stipends.

Questions about the program should be addressed to Suraya Barbee at sbarbee@osbar.org

Job Postings

Kilmer, Voorhees & Laurick

Kilmer, Voorhees & Laurick a ten-lawyer firm in the heart of NW Portland specializing in civil litigation for more than 30 years is looking for two full-time attorneys. Looking for 2-6-year attorneys to add to the firm's practice or integrate your current clients. Excellent opportunity for attorneys who wish to expand their practices. Our growing practice consists of commercial insurance defense, first-party insurance coverage, construction, and business litigation in both state and federal courts. Additional opportunities for those who would like to expand a transactional practice as well. Remote practice is viable if you choose. Washington admission is a plus, but not necessary. All inquiries will be confidential. Please send a resume and description of your current practice to ccarson@kilmerlaw.com or rmuth@kilmerlaw.com.

Schwabe, Williamson & Wyatt

Experienced Corporate Attorney

Schwabe is seeking an experienced attorney looking to join a well-established business transactions department with a sophisticated corporate practice serving domestic and international clients in challenging transactions. The ideal candidate will have the following qualifications:

- Minimum of six years of experience in one or more of the areas of mergers and acquisitions, private placements, credit agreements, entity formations, emerging companies, securities, and general corporate law
- Experience serving clients in at least one of our seven key industries
- Ability to manage complex transactions independently, and ability and willingness to train and manage the work of junior associates
- Excellent legal skills and reputation
- Strong client service ethics
- Entrepreneurial and growth mindset

Will consider placement of this position in any of the firm's seven offices; flexible work-from-home/work-from-office options available.

The firm provides a team-oriented working environment with a competitive salary and benefits. Candidates should submit a PDF of their cover letter, resume, law school transcripts, and a writing sample and direct to Michelle Baird-Johnson, Director of Talent Acquisition & Integration, via the firm's website, schwabe.com/careers-attorneys. Inquiries are maintained in confidence.

Sussman Shank LLP

Trust and Estate Tax Attorney (Full-Time)

We have an immediate opening in our business practice group, for a motivated tax lawyer who focuses on taxable estate planning, trust and estate administration, closely-held business succession planning, and related transactions. The position requires strong academic credentials and excellent written and oral communication skills. An ideal candidate has completed an LLM program in tax (or has comparable tax experience), has experience working directly with high-net-worth clients, and has the capacity for, and shows dedication to, business and practice development.

Please address cover letters and resumes to our Chief Operating Officer, Steven T. Seguin. sseguin@sussmanshank.com; Phone: 503.227.1111.

Watkinson Laird Rubenstein, P.C

Litigation Associate

Watkinson Laird Rubenstein, P.C., is seeking a litigation associate to fill an immediate need. At WLR, we are proud of what sets us apart. Our staff and outstanding attorneys have decades of experience in a wide variety of legal specialties, and our work is guided by principles established over sixty years ago.

Our legal professionals genuinely enjoy working alongside each other while providing the highest level of service to our clients. Our firm is focused on serving the unique legal needs of each community from Portland all the way down through the Rogue Valley. We provide a broad range of legal services, emphasizing business law, real estate, estate planning and administration, employment law, and litigation, with locations in Eugene, Grants Pass, Roseburg, and Sunriver.

WLR invites inquiries from bright, talented, and creative practicing attorneys, with the desire to live and work in the vibrant communities we serve. We are flexible on location; candidate just needs to live near one of our four office locations.

If you are looking to grow your career alongside peers committed to supporting each other's personal and professional development, we encourage you to introduce yourself to our firm. Details on our firm and a link to open positions can be found at https://www.wlrlaw.com/careers.

Oregon State Bar Business Law Section

The mission of the Oregon State Bar Business Law Section is to provide excellent service to the diverse group of business law practitioners throughout the State of Oregon by providing regular, timely, and useful information about the practice of business law, promoting good business lawyering and professionalism, fostering communication and networking among our members, advocating improvement of business law, and supporting Oregon's business infrastructure and business community.

Articles in this newsletter are for informational purposes only, and not for the purpose of providing legal advice. The opinions expressed in this newsletter are the opinions of the individual authors and may not reflect the opinions of the Oregon State Bar Business Law Section or any attorney other than the author. Comments can be sent to the editor at carole424@aol.com.