ETHICAL ISSUES
WHEN INVESTING IN CLIENTS

Mark J. Fucile

Fucile & Reising LLP
115 NW First Ave., Suite 401
Portland, OR 97209
503.224.4895
mark@frllp.com
www.frllp.com

Washington Law Institute
May 18, 2007
Seattle

Mark J. Fucile of Fucile & Reising LLP handles professional responsibility, regulatory and attorney-client privilege matters and law firm related litigation for lawyers, law firms and corporate and governmental legal departments throughout the Northwest. Mark is a past chair and a current member of the Washington State Bar Association Rules of Professional Conduct Committee, is a former member of the Oregon State Bar Legal Ethics Committee and is a member of the Idaho State Bar’s Section on Professionalism & Ethics. Mark was also a member of the WSBA’s Special Committee for the Evaluation of the Rules of Professional Conduct. He writes the quarterly Ethics & the Law column for the Washington State Bar News and the monthly Ethics Focus column for the Multnomah (Portland) Bar’s Multnomah Lawyer. Mark is a contributing author/editor for the current editions of the WSBA’s Legal Ethics Deskbook and the OSB’s Ethical Oregon Lawyer. He is admitted in Washington, Oregon, Idaho, Alaska and the District of Columbia. Mark received his B.S. from Lewis & Clark College and his J.D. from UCLA.
Investing in clients has long been a dicey prospect. The disciplinary reporters are filled with cases that illustrate the conflicts—whether the lawyer handled the transaction involved for the client or simply participated in a business deal with a client where the client implicitly relied on the lawyer for legal advice. Moreover, because conflicts in this setting easily translate into breaches of the fiduciary duty of loyalty, unwaived conflicts can translate with equal ease into claims, fee forfeiture and violations of the Consumer Protection Act.

Although the ardor for investing in clients cooled in the wake of the “dot com bust,” lawyers and law firms still find investment opportunities coming their way—either from their own initiative or clients’ requests. The Rules of Professional Conduct do not prohibit a lawyer from investing in a client—either directly or in lieu of a fee. Rather, they require clear disclosure and client consent. RPC 1.8(a) expresses this wariness by making the consent requirements even more exacting than in most other conflict scenarios:

“A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

“(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully
disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

“(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

“(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer’s role in the transaction, including whether the lawyer is representing the client in the transaction.”

Lawyers and law firms considering investing in clients would be wise to include four items on their list of required reading.

The first is ABA Formal Ethics Opinion 00-418. Opinion 00-418 was issued in July 2000 near the peak of the “dot com boom” when law firms saw investing in clients as a lucrative source of new revenue. Although not a “cookbook” for aspiring lawyer-venture capitalists, Opinion 00-418 does a good job of walking through ABA Model Rule 1.8(a) (which is similar to its Washington counterpart)³, identifying the potential pitfalls and offering useful tips to minimize the risks of claims to lawyer-investors. On these last two points, Opinion 00-418 stresses throughout the absolutely essential need to thoroughly disclose to a client the risks of having a lawyer-investor advising on a transaction and the equally essential need to document the client’s consent.⁴

The second is Holmes v. Loveless, 122 Wn. App. 470, 94 P.3d 338 (2004). Holmes involved a more mundane, but very lucrative, investment in a real estate development that a law firm took in return for discounting its fees during a two-year start
up period. Over nearly 30 years, the investment generated $380,000 on the initial $8,000 in discounted fees. The client eventually argued that continued payment would constitute an unreasonable fee under both RPC 1.8(a) and RPC 1.5(a), which governs fees generally. The Court of Appeals concluded that although the arrangement may have been reasonable when it began, the fee generated became unreasonable as time went by because the lawyer’s risk diminished while the certainty and amount of the fee 30 years later became disproportionate. The Court of Appeals refused to enforce the agreement going forward. *Holmes’* temporal gauge for measuring the reasonableness of a fee suggests that lawyers need to emphasize in their disclosure letters to clients that if the business is wildly successful the lawyers may receive a fee far in excess of what was available under an hourly fee arrangement.

The third is *In re McMullen*, 127 Wn.2d 150, 896 P.2d 1281 (1995). *McMullen* concerned a series of loans from a client to her lawyer. The lawyer included disclosures in the loan documentation but the client was elderly and unsophisticated. The Supreme Court concluded that the client did not understand the transactions involved and, therefore, the lawyer violated RPC 1.8(a) notwithstanding the disclosures. The point *McMullen* illustrates is that investing in clients should be left to situations where the clients are sophisticated and will understand the nature of the disclosure.5

The fourth is *Cotton v. Kronenberg*, 111 Wn. App. 258, 44 P.3d 878 (2002), rev. *denied*, 148 Wn.2d 1011, 62 P.3d 890 (2003). The lawyer in *Cotton* took real estate as an element of a fee and was later disqualified before the legal services were completed. The Court of Appeals found that RPC 1.8(a)’s “reasonableness” requirement continued over the life of the agreement and that the lawyer’s disqualification before completing
the services rendered the transaction unreasonable. *Cotton* involved claims for breach of fiduciary duty, fee forfeiture and violations of the Consumer Protection Act. As such, it serves as a sobering example of the range of “bad things” that can happen if the inherent conflicts of a lawyer taking an investment in lieu of a fee are not fully disclosed and client consent is not documented.

The cases involving lawyer investments in clients display motives ranging from the best to the worst on the part of the lawyer-investors. What they all share, however, is the theme that this area is fraught with potential conflicts and that lawyers’ motives will be subject to intense scrutiny after the fact. In that context, the best investment a lawyer can make is a thorough conflict waiver.

---

1 See, e.g., *In re McKeen*, 148 Wn.2d 849, 64 P.3d 1226 (2003) (lawyer both formed and invested in a company with clients he was representing); *In re Johnson*, 118 Wn.2d 693, 826 P.2d 186 (1992) (client implicitly relying on lawyer for legal advice regarding a loan); see generally *In re McGlothlen*, 99 Wn.2d 515, 663 P.2d 1330 (1983) (discussing business transactions with clients).


3 ABA Model Rule 1.8(a) was amended to its current version in 2002. It is that updated version upon which Washington RPC 1.8(a) (as amended effective September 2006) is patterned. Comments 1 through 4 to RPC 1.8 discuss lawyer-client investments further.

4 See also WSBA Informal Ethics Opinions 1557 (1994), 1198 (1988) and 1191 (1988), all of which deal with investments in clients and are available on the WSBA’s web site at www.wsba.org.

5 Even with sophisticated clients, enforceability can be a risk. See, e.g., *Valley/50th Avenue, L.L.C., v. Stewart*, __ Wn.2d __, __P.3d __, 2007 WL 616063 (Mar. 1, 2007) (reversing summary judgment on the issue of whether a lawyer-client business transaction with a sophisticated client was enforceable in light of alleged inadequacies in disclosure under RPC 1.8(a)).