

ETHICAL ISSUES WHEN INVESTING IN CLIENTS

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Note: This is an updated version of an Ethics & the Law column published in the Washington State Bar News in November 2005 as “Taking Stock: Investing in Clients.” Since Taking Stock was written, the Washington Rules of Professional Conduct were amended effective September 2006. This paper reflects the new RPCs and their accompanying comments.

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.¹ 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.²

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 McKean*, 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).

² See *Eriks v. Denver*, 118 Wn.2d 451, 824 P.2d 1207 (1992) (discussing the relationship between violations of the professional rules governing conflicts and corresponding breaches of the fiduciary duty of loyalty); *Short v. Demopolis*, 103 Wn.2d 52, 691 P.2d 163 (1984) (applying the CPA to the business aspects of law practice).

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)).