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Danger Zone:
Business Deals with Clients

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The Rules of Professional Conduct do not prohibit lawyer-client business transactions outright. At the same time, the applicable rule—RPC 1.8(a)—sets very high standards for the lawyer or firm involved. Courts have also long closely scrutinized lawyer-client business transactions—with the Washington Supreme Court describing them on more than one occasion as "prima facie fraudulent" (*see, e.g., In re McGlothlen*, 99 Wn.2d 515, 525, 663 P.2d 1330 (1983)). Despite their inherent risks, lawyer-client business transactions occur in both good times and bad. When the economy is hot, lawyers may take stock in lieu of fees from promising start-up clients. When it's not, lawyers may be forced to take additional security from clients struggling with fees long overdue.

In this column, we'll look at three facets of lawyer-client business transactions. First, we'll survey the parameters of the rule. Second, we'll discuss the standards that lawyers must meet when engaging in a lawyer-client business transaction. Finally, we'll outline the consequences that lawyers face if they don't meet the standards involved.

Parameters of the Rule

RPC 1.8(a) includes two broad categories of lawyer-client business dealings: "business transactions;" and the acquisition of "ownership, possessory, security or other pecuniary interests adverse to a client[.]" They are framed in the disjunctive and, therefore, both do not need to be present for the rule to be triggered.

Business transactions cover a wide spectrum of lawyer-client deals, ranging from loans from the client to the lawyer (*see, e.g., In re McMullen*, 127 Wn.2d 150, 896 P.2d 1281 (1995)), to purchasing a house out of the estate of a probate client (*see, e.g.*, *In McGlothlen*, 99 Wn.2d 515). The rule also applies under RPC 5.7 to transactions involving a law firm affiliate selling ancillary services to a client. Standard commercial transactions, however, are generally exempted by Comment 1 to RPC 1.8. Examples of this exclusion include having a checking account at a bank client or buying electric power from a utility client.

Ownership, possessory or security interests cover an equally wide spectrum of lawyer-client arrangements, ranging from a law firm's investment in a client's business (*see, e.g.*, *Holmes v. Loveless*, 122 Wn. App. 470, 94 P.3d 338 (2004)) to a joint venture between a lawyer and the client (*see, e.g., In re Corporate Dissolution of Ocean Shores Park, Inc.*, 132 Wn. App. 903, 134 P.3d 1188 (2006)).

Comment 1 to RPC 1.8 notes that the rule "does not apply to ordinary fee arrangements between client and lawyer[.]" That said, three important qualifiers are in order. First, Comment 1 goes on to apply the rule when “the lawyer accepts an interest in the client’s business or other nonmonetary property as payment of all or part of a fee.” Second, Comment 16 to RPC 1.8 applies the rule when a lawyer acquires “by contract a security interest in property other than that recovered through the lawyer’s efforts in . . . litigation[.]” Third, a modification of a fee agreement that brings with it security for fees already owed invokes the rule (*see Valley/50th Avenue, L.L.C. v. Stewart*, 159 Wn.2d 736, 153 P.3d 186 (2007)).

For the rule to apply, generally there must be a current attorney-client relationship. In *Rafel Law Group PLLC v. Defoor*, 176 Wn. App. 210, 308 P.3d 767 (2013), and *DKS Ventures, LLC v. Kalch*, 2011 WL 4829724 (E.D. Wash. Oct. 12, 2011) (unpublished), for example, the courts involved concluded that no attorney-client relationships existed and, therefore, RPC 1.8(a) did not apply. But, the rule applies even with prospective clients under Comment 1 to RPC 1.8 when the lawyer or firm is taking stock or other nonmonetary property in lieu of fees. The concurring opinion in *Rafel* notes that the Washington Supreme Court has not yet addressed whether RPC 1.8(a) applies when a lawyer is negotiating with a prospective client over security for fees not yet incurred. WSBA Advisory

Opinion 2209 (2012) makes the same point and recommends meeting the requirements of the rule in this circumstance as a "best practice."

Standards

RPC 1.8(a) sets out the three basic standards that must be met for a lawyer-client business transaction to pass muster:

> "(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 an independent lawyer 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."

Whether a transaction is "fair" will be assessed over the life of the deal. In *Holmes v. Loveless*, 122 Wn. App. 470, for example, the Court of Appeals refused further enforcement of a business deal that had generated roughly $380,000 for the lawyers involved over 30 years for an original $8,000 discount in their fees. The Supreme Court has also added that the sophistication of the client does not excuse the disclosures required (*see, e.g., In re Miller*, 149 Wn.2d 262, 280, 66 P.3d 1069 (2003); *Valley/50th Ave., L.L.C. v. Stewart*, 159 Wn.2d at

745-46). When the lawyer is also providing legal advice on the matter involved, Comment 3 to RPC 1.8 emphasizes that the lawyer's disclosure must also include "the risks associated with the lawyer's dual role as both legal adviser and participant in the transaction[.]"

For lawyers and their firms thinking about doing a business transaction with a client, ABA Formal Ethics Opinion 00-418 should be on their reading list. The opinion, which was issued when investing in clients was becoming more prominent during the "dotcom bubble," focuses on taking stock in lieu of fees. While not a "cookbook," it contains sound practical advice both for complying with the professional rules and lessening (but not eliminating) the risks involved.

Consequences

With any conduct that the Supreme Court has labeled "prima facie fraudulent," it should not be surprising that regulatory discipline is a common sanction for lawyers who do not meet the high bar for lawyer-client business transactions. Discipline, however, is not the sole remedy available. Because the conflict rules involved reflect the underlying fiduciary duty of loyalty, the clients affected may also have a breach of fiduciary duty claim against the lawyer—with both damages and fee disgorgement possible (*see, e.g., Cotton v. Kronenberg*, 111 Wn. App. 258, 44 P.3d 878 (2002)).

In *LK Operating, LLC v. Collection Group, LLC*, 181 Wn.2d 48, 331 P.3d 1147 (2014), the Supreme Court offered a powerful reminder of another potential consequence: the business deal involved may not be enforceable. Although that remedy is neither new nor novel, the Supreme Court in *LKO* explained it in detail. The Supreme Court noted (at 85) that it had "previously and repeatedly held that violations of the RPCs or the former Code of Professional Responsibility in the formation of a contract may render that contract unenforceable as violative of public policy." The Supreme Court stressed that because the requirements of RPC 1.8(a) and the formation of the contract concerned are essentially woven together, a lawyer-client business transaction that does not meet the standards of the rule is "presumptively" unenforceable. Although declining to set a precise gauge for overcoming the presumption, the Supreme Court stressed (at 89) that a lawyer seeking enforcement would need to demonstrate that the resulting contract does not violate public policy:

> "To justify a transaction with a client, the attorney has the burden of showing: '"(1) there was no undue influence; (2) he or she gave the client exactly the same information or advice as would have been given by a disinterested attorney; and (3) the client would have received no greater benefit had he or she dealt with a stranger."'" (Citations omitted.)

If the lawyer cannot overcome the presumption, the Supreme Court in *LKO* found that rescission is an appropriate remedy.

Summing Up

Both the professional rules and the courts view lawyer-client business transactions with a sufficiently skeptical eye that lawyers should think long and hard about whether to do a deal with a client. If they do, it is critical that they meet the very high standards imposed by both the rules and reviewing courts.

ABOUT THE AUTHOR

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